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TREASURY NEWS

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For Release Upon Delivery

March 26, 1985

STATEMENT OF THE HONORABLE JAMES A. BAKER, III

SECRETARY OF THE TREASURY

COMMITTEE ON APPROPRIATIONS

SUBCOMMITTEE FOR TREASURY, POSTAL SERVICE,

AND GENERAL GOVERNMENT

MR. CHAIRMAN, MEMBERS OF THE SUBCOMMITTEE:

I am pleased to appear before this Subcommittee for the first time to discuss the operating budget for the Treasury Department for Fiscal Year 1986.

As this Subcommittee is well aware, and as I have come to understand better during the past several weeks, the Treasury Department carries out functions that are truly essential to the existence of our Federal system of government. We administer the Nation's tax system, and collect the government's revenues. We manage the government's fiscal affairs, including paying its bills and financing the nation's public debt. We manufacture the currency and coin that are essential to the nation's commerce and economic well-being. We help regulate our country's financial institutions. We process passengers and cargo coming into the

country, enforcing import and export laws. We carry out basic federal law enforcement responsibilities, including protecting the President, Vice-President, as well as other dignitaries. We participate in the effort to combat illegal drug smuggling, and administer firearms and explosives laws. Finally, we advise the President on monetary, economic, and tax policies.

To continue to carry out the functions of the Treasury Department in Fiscal Year 1986, we are requesting a total budget of $5.3 billion and 121,006 positions. These funding and staffing totals include $6 million and 75 positions for the administration of the revenue sharing program; that request is reviewed by the Appropriations Subcommittee for Housing and Urban Development and Independent Agencies.

Our budget request for FY 1986 represents a decrease of $45 million, or 0.8%, below the comparable Fiscal Year 1985 levels.

In addition to these funding and staffing requests for the operations of the Treasury Department, our Fiscal Year 1986 budget reflects a proposed transfer of certain responsibilities of the Small Business Administration to the Treasury Department.

Our budget includes $74 million and 1,650 positions for the administrative costs of servicing existing direct loans and monitoring the servicing of guaranteed loans. The budget also includes $2.6 billion for expenses directly associated with the portfolio, including writing off defaulted loans. Our understanding is that this request concerning the transfer of the Small Business Administration will not be taken up by the Treasury Appropriations Subcommittee, but will be covered by the Commerce, Justice, State and Judiciary Subcommittee.

The Fiscal Year 1986 budget for the Treasury Department has several major objectives. First, the overall budget request reflects our participation in the governmentwide 1-year freeze in total spending other than debt service. Specifically, we have maintained spending levels appropriated in the Fiscal Year 1985 Continuing Resolution plus critical supplemental requests.

Second, our budget reflects two specific governmentwide proposals included in the President's budget -- a reduction of 5% in Federal civilian pay effective January, 1986, and a 10% reduction in administrative and overhead costs.

The 5% pay reduction will produce savings of approximately $135 million in the Treasury Department's budget for Fiscal Year 1986.

To accomplish the 10% reduction in administrative costs, we will streamline administrative and support operations. Every Treasury organization will participate in this effort; the estimated savings in Fiscal Year 1986 is $64 million. The majority of these savings will be accomplished in the Internal Revenue Service and the U.S. Customs Service. The IRS reduction reflects cuts in personnel, printing, and general support operations. The reduction in the U.S. Customs Service reflects the centralization of administrative functions, certain organizational realignments, and various operational and management efficiencies.

Strengthening law enforcement capabilities is a third objective of this budget.

We will increase our participation in the President's Organized Crime Drug Enforcement Task Forces. We are requesting supplemental funding of $6.5 million in Fiscal Year 1985 to support Treasury's participation in the 13th City Task Force in Miami. These Task Forces have achieved dramatic results. Since October of 1982, the Task Forces have initiated over 800 cases, which have resulted in over 4,300 indictments and more than 1,600 convictions. Over two-thirds of these cases have been the direct result of financial investigations. These efforts have focused on the criminal leadership in this country; this has resulted in the breakup of many formerly well-financed and tightly-controlled organized crime operations.

We are moving to strengthen our drug interdiction efforts. We will acquire three additional P-3A aircraft this summer for surveillance. We have recently completed the installation of a third air-to-air surveillance aerostat in the Bahamas. Further, we will acquire eight new, high endurance, tracking aircraft this year with funds appropriated in FY 1984.

Our Fiscal Year 1986 budget for air interdiction represents an increase of $16 million, or 36%. These funds will be used to operate the P-3A aircraft to be acquired this summer, to install radars and night vision devices in certain interception aircraft, to operate up to two additional helicopters, and to begin developmental work on a 360 degree search radar system.

The Treasury Department is most appreciative of the assistance we have received from the Defense Department over the past several years in our efforts to stem the flow of illegal drugs into the country. As I am sure you are all aware, the drug traffic from Central and South America, through the Caribbean, is an increasingly serious problem. Treasury must do everything that we can to work together with all Federal agencies who can aid in this war on drugs. To this end, I am asking the Assistant Secretary of the Treasury for Enforcement and Operations to meet

with the Defense Department to develop a joint plan for strengthening our anti-smuggling capabilities in the Caribbean Basin.

Our budget contains a proposed Fiscal Year 1985 supplemental of $4.1 million to provide security and related equipment for the perimeter of the White House, Naval Observatory, and Main Treasury. We believe that these improvements are critical due to the recent events world-wide and the increased threat of terrorist activity in this country.

In order to provide improved handling of seized property, we are requesting $6 million in Fiscal Year 1985 and $8 million in Fiscal Year 1986 for a new Customs Forfeiture Fund. This Fund was authorized by Congress last year in both the Trade and Tariff Act of 1984 and the FY 1985 Continuing Resolution. The Fund operates using the net proceeds from the disposition of seized and forfeited merchandise and currency. We will use the Fund primarily to pay for expenses related to seizures and to equip forfeited vessels, vehicles, and aircraft for use in narcotics interdiction. We believe that this Fund not only will enable us to increase significantly the profits from the sale of seized assets, but also will increase the equipment available to us for drug interdiction.

A fourth major objective of this budget is to continue major efforts to modernize Treasury systems and equipment. Even within an overall spending freeze, we cannot postpone the introduction of new technology and modern equipment. These investments are essential to the Department's ability to handle growing workloads and to relieve future pressures for growth in personnel.

To help modernize the tax administration system, our budget includes resources to continue two major projects now under development -- the Automated Examination System and the Tax System Redesign Project. The Automated Examination System will equip IRS enforcement personnel with modern equipment to help them in the auditing of tax returns. When this system is fully implemented, productivity is expected to increase by as much as 25%. The Tax System Redesign Project is a longer-term effort to enable IRS to create an overall modernized system that will meet the requirements of the 1990's.

The U.S. Customs Service is seeking an additional $14 million to automate its major commercial processing procedures, to develop an integrated data telecommunications network, to replace the current 15 year old Treasury Enforcement Communications System, and to apply new technology to drug interdiction efforts. Customs' Automated Commercial System will

involve automated processing of entries from the trade community, eliminate redundancies, reduce paper, and enhance selectivity procedures in the cargo review process.

The Department's fiscal bureaus will continue to improve the government's financial systems, the means by which we collect, manage, and disburse federal funds and finance the public debt. The Financial Management Service is requesting an additional $14 million to complete replacement of the Service's headquarters computer, continue efforts to upgrade the government's collection and payment systems, and enhance the financial telecommunications network. The Bureau of the Public Debt is requesting $3.5 million for funding for the first phase of a project to replace the Bureau's mainframe computer and to purchase new equipment for the processing of Savings Bonds issue stubs.

A fifth major objective of this budget is to strengthen the tax administration system to collect additional revenues that are owed by taxpayers. Beginning in FY 1987, we will add 2,500 positions for Examinations in each of three fiscal years, for a total of 7,500 positions. This initiative will produce an estimated $4.6 billion in additional revenue during Fiscal Years 1987-1989. This proposal is recommended by the President's

Private Sector Survey on Cost Control, and involves the collection of taxes that are legitimately owed. It is only equitable that we not ask the vast majority of American taxpayers, who pay their fair share of taxes, to have to subsidize those who do not contribute. To implement this initiative, we will conduct some advance hiring at the end of Fiscal Year 1986.

Our budget also provides, within existing resource levels, for implementation of certain provisions of the Deficit Reduction Act of 1984. Specifically, we will enforce the new tax shelter registration requirements, as well as provisions which will provide additional information to IRS. The tax shelter requirements are especially important as they will provide IRS with the ability to identify and target abusive shelters for enforcement action.

A sixth major objective of this budget is to accomplish productivity savings through improved management and automated systems. Specifically, our budget identifies savings of $23 million and 748 positions. The majority of these savings will result from efficiencies in the processing of tax returns and automation of the collection field function.

In addition to the major objectives that we have identified, our budget anticipates a large and growing workload. Some examples include:

-- IRS will process 178.7 million tax returns, an increase of 3% above the previous year.

-- We expect to audit or contact over 2.7 million taxpayers, close an estimated 3.3 million delinquent tax accounts, and provide some form of assistance to over 55 million taxpayers.

-- We anticipate that 311 million passengers will arrive at U.S. borders; this represents a growth of 4.3%. We will process 7.1 million formal entries of merchandise -- 6% more than in FY 1985.

-- Treasury will issue over 80 million savings-type securities and redeem more than 82 million. We will make over 731 million payments, an increase of 2% above the prior year.

-- We will print 6.6 billion pieces of currency, an increase of 6.5%, and 35.8 billion postage stamps, an increase of 3%. We will manufacture approximately 16.2 billion coins.

In summary, in terms of the major overall changes to the budget, we are seeking:

-- $67.1 million for program enhancements, related primarily to the objectives that I have described;

-- $14.6 million for increased workload, especially in the area of tax administration;

-- $262.4 million for price increases in such areas as communications, office space, travel, and utilities; and

-- an offset of $387.3 million in program reductions. These include the 5% pay cut, the 10% savings in administrative areas, and various productivity and one-time savings throughout the Department.

FISCAL YEAR 1985 PROPOSALS

Our budget contains supplementals totalling $77.1 million and rescissions totalling $9.5 million for Fiscal Year 1985. The supplemental requests include $44.9 million to cover 50% of the pay increase effective this past January and program supplementals of $32.2 million.

The program supplementals include funds to cover the recent postage rate increase for the Financial Management Service; to establish the 13th Organized Crime Drug Enforcement Task Force in Miami; to make certain security improvements to the White House, Naval Observatory, and Main Treasury; to provide a one-time capitalization increase to the IRS' Tax Lien Revolving Fund; to support the Customs Seizure Fund; and to establish User Fees at Certain Small Airports.

The proposed rescissions of $9.5 million are in response to Section 2901 of the Deficit Reduction Act of 1985. That Section requires executive branch agencies to achieve savings in costs associated with motor vehicles, travel, consulting services, printing, and public affairs.

Mr. Chairman, that summarizes the major proposals of the Treasury Department. I shall be happy to answer any questions that the Subcommittee may have.

TREASURY NEWS

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FOR RELEASE AT 4:00 P.M. March 26, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,100 million, to be issued April 4, 1985. This offering will result in a paydown for the Treasury of about $25 million, as the maturing bills are outstanding in the amount of $13,115 million, including $1,207 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities and $2,453 million currently held by Federal Reserve Banks for their own account. The two series offered are as follows:

92-day bills (to maturity date) for approximately $6,550 million, representing an additional amount of bills dated January 3, 1985, and to mature July 5, 1985 (CUSIP No. 912794 HR 8), currently outstanding in the amount of $7,065 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $6,550 million, representing an additional amount of bills dated October 4, 1984, and to mature October 3, 1985 (CUSIP No. 912794 HM 9), currently outstanding in the amount of $8,311 million, the additional and original bills to be freely interchangeable.

Both series of bills will be issued for cash and in exchange for Treasury bills maturing April 4, 1985. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

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Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Standard time, Monday, April 1, 1985. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit

of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on April 4, 1985, in cash or other immediately-available funds or in Treasury bills maturing April 4, 1985. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

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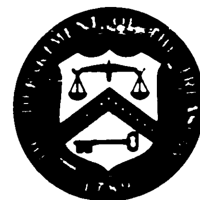
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FOR IMMEDIATE RELEASE March 26, 1985

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $ 6,255 million of $ 21,807 million of tenders received from the public for the 4-year notes, Series L-1989, auctioned today. The notes will be issued April 1, 1985, and mature March 31, 1989.

The interest rate on the notes will be 11-1/4%. The range of accepted competitive bids, and the corresponding prices at the 11-1/4% interest rate are as follows:

	Yield	Price
Low	11.30%	99.843
High	11.32%	99.780
Average	11.30%	99.843

Tenders at the high yield were allotted 20%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 238,264	$ 45,264
New York	19,379,904	5,532,844
Philadelphia	27,300	26,800
Cleveland	174,449	64,449
Richmond	85,823	51,223
Atlanta	52,091	37,091
Chicago	737,876	177,476
St. Louis	120,358	116,358
Minneapolis	79,497	25,097
Kansas City	94,716	89,216
Dallas	16,850	13,250
San Francisco	793,918	70,518
Treasury	5,517	5,517
Totals	$21,806,563	$6,255,103

The $ 6,255 million of accepted tenders includes $ 914 million of noncompetitive tenders and $ 5,341 million of competitive tenders from the public.

In addition to the $ 6,255 million of tenders accepted in the auction process, $300 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $365 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 a.m. E.S.T.
March 27, 1985

STATEMENT OF
DENNIS E. ROSS
ACTING DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON JUDICIARY
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on the Federal income tax policy issues raised by the proposed sale by the Federal government of its interest in the Consolidated Rail Corporation ("Conrail") to Norfolk Southern Corporation ("Norfolk" or "Norfolk Southern"). I have attached to my statement a letter that we have sent to Senator Danforth, Chairman of the Senate Commerce Committee's Subcommittee on Surface Transportation, containing a more detailed analysis of these tax policy issues.

Section 401 of the Regional Rail Reorganization Act of 1973 enacted by the Northeast Rail Service Act of 1981 directed the Secretary of Transportation to submit to the Congress a plan for the sale of the Federal government's interest in approximately 85 percent of Conrail's common stock to (1) ensure continued rail service; (2) promote competitive bidding for the stock; and (3) maximize the government's return on its investment in Conrail. After careful review of a number of purchase proposals, the Secretary of Transportation has recommended sale of Conrail to Norfolk Southern.

The Treasury Department has consulted closely with the Department of Transportation with regard to the tax policy aspects of the sale of Conrail. Our advice to the Transportation

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Department has been guided by two basic policy objectives: (1) that the sale of Conrail should not provide the purchaser with Federal income tax benefits that would not be available in an analogous transaction between private parties; and (2) that the Internal Revenue Service ("IRS"), in its role as administrator of the Federal income tax laws, should not be prevented by the sales agreement or enabling legislation from treating Conrail in the same manner as it would any other taxpayer.

Treatment of Conrail's Tax Benefits

Under current law there are significant differences in the Federal income tax treatment of a sale of stock and a sale of the assets of a corporation. In general, a purchaser of the stock of a corporation receives a tax basis in the stock purchased equal in amount to the consideration paid for such stock. Other than this change in tax basis for the stock purchased, the sale of stock of a corporation generally does not trigger tax consequences either to the purchaser or to the corporation whose stock is sold. Accordingly, the existing tax attributes of the acquired corporation generally remain intact even though the corporation is owned by different persons.

Given the treatment of stock purchase transactions under current law, if the proposed sale of Conrail stock occurred between private parties the tax attributes of Conrail, such as its net operating loss carryforwards, investment tax credit carryforwards, and asset tax basis (including the so-called "frozen asset base"), would remain intact following the sale. The tax consequences of the proposed sale of Conrail to Norfolk Southern would depart from this private transaction model in that certain of Conrail's tax attributes would not survive the sale transaction. Thus, pursuant to a closing agreement to be entered into between Conrail and the IRS, Conrail's net operating loss, investment tax credit and other carryforwards would, with certain exceptions, not be available for carryforward to taxable years beginning after the date of sale (hereinafter, the "Closing").* At the same time, other Conrail tax attributes, in particular, Conrail's asset basis, would, as in a private party transaction, carry over to taxable years after the Closing.

We believe the different treatment of Conrail's tax carryforwards on the one hand and its asset basis on the other is appropriate for a number of reasons. Conrail's existing carryforwards arose during the period of the Federal government's ownership and are for the most part attributable to monies invested in Conrail by the Federal government. The same is not

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* The closing agreement would also provide that Conrail's taxable year would terminate as of the Closing.

true of Conrail's asset basis. Although the assets held by Conrail have changed substantially since its formation in 1976, data provided to us by the Department of Transportation indicates that the aggregate tax basis of its assets (as of December 31, 1983) is roughly equal to what it was at that time. Thus, the proposed transaction would return Conrail to the private sector with substantially the same asset basis as at the time the Federal government acquired it.*

We, of course, recognize that the purchase price in a sale transaction will reflect the extent to which advantageous tax attributes carry over in an acquisition. Where the Federal government is the seller, however, any gain in purchase price from a carry over of favorable tax attributes must be weighed against future revenue losses attributable to the purchaser's utilization of the tax attributes. This weighing is more difficult to the extent the purchaser's ability to use the attributes is uncertain. In this respect, the value of Conrail's carryforwards is inherently more speculative than the value of its asset basis, since the carryforwards would be of future value only to the extent that annual depreciation deductions generated by Conrail's asset basis had already been fully utilized. It would thus appear reasonable for the Federal government to require the termination of Conrail's carryforwards rather than speculate as to their value, while, in accord with the model of a private transaction, permitting Conrail to return to the private sector with its asset basis intact.

It should also be noted that the treatment of Conrail's tax attributes in the proposed sale is similar to what was approved by Congress at the time of Conrail's formation. Thus, legislation adopted in connection with Conrail's formation, now reflected in section 374(c) of the Internal Revenue Code (the "Code"), provided that the net operating loss carryforwards of Conrail's predecessors would not carry over to Conrail whereas Conrail would inherit its predecessors' asset basis. The tax consequences of the proposed sale of Conrail to Norfolk Southern would generally conform to that legislative precedent.

Finally, the carry over of Conrail's asset basis should not cause a reduction in Federal income tax revenues collected from Conrail. Although Conrail is a taxable entity, it has not

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* If the effects of inflation are accounted for, Conrail's current asset basis is, of course, much less than at the time of its formation. Moreover, since the value of Conrail's assets today likely exceeds their value at the time of Conrail's formation, the built-in loss in Conrail's assets (i.e., the excess of their basis over value) is likely smaller today than it was at Conrail's formation.

previously paid Federal income tax, nor would it in the foreseeable future given its substantial carryforwards and the high basis in its assets. Because Conrail's carryforwards would not survive the proposed sale to Norfolk Southern, the transaction would, if anything, accelerate the point at which Conrail would become a taxpaying corporation.

Separation of Government Roles

The IRS is charged with administration and enforcement of the Federal income tax laws. In order to effectively carry out this mission, no preference or special rules can be adopted for any taxpayer.

We believe the Department of Transportation's plan for the sale of Conrail is consistent with the IRS' special responsibilities as administrator of the Federal income tax laws. Most importantly, the plan does not restrict the IRS from auditing or assessing tax liabilities against Norfolk Southern or Conrail after the sale. To the extent Norfolk Southern would be protected in the proposed transaction against possible tax liabilities of Conrail or of Norfolk, such protection would be provided in the form of a warranty, rather than covenant by the IRS, in order that the IRS be able to fulfill its mission of evenly administering and enforcing the Federal income tax laws. Certain legislation, which is included in the proposal submitted by the Department of Transportation, would be necessary to implement a procedure for Norfolk Southern to enforce such tax warranties against the Federal government.

Special Legislation for Conrail's Employee Stock Ownership Plan

Certain legislation is also required to qualify for tax purposes Conrail's employee stock ownership plan that was created by earlier legislation. This legislation, which is included in the proposal submitted by the Department of Transportation, is necessary because of the possibly unique form of Norfolk Southern's arrangements with Conrail's labor unions and employees and the unusual structure of Conrail's employee stock ownership plan.

* * *

This concludes my prepared remarks. I would be happy to respond to your questions.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

March 27, 1985

Dear Mr. Chairman:

This is in response to your request for our views of the Federal income tax policy issues raised by the proposed sale of the Federal government's interest in the Consolidated Rail Corporation ("Conrail") to Norfolk Southern Corporation ("Norfolk"). In preparing this response, we have not comprehensively examined all potential Federal income tax consequences of the proposed sale, but have limited our analysis to certain issues of tax policy raised by the Federal government's ownership of Conrail and the form of the proposed transaction. In addition, our analysis has assumed that the details of the proposed transaction are accurately reflected in the Memorandum of Intent signed February 8, 1985 by Norfolk and the Department of Transportation, and in H.R. 1449 and S. 638, the pending legislation that would authorize and establish terms for the sale of Conrail.

We have previously consulted with the Department of Transportation with regard to its Congressionally mandated plan for the return of Conrail to the private sector. We thus have advised the Department of Transportation as to Federal income tax aspects of the sale of Conrail and have reviewed the tax implications of the bids for Conrail and of draft language for the Memorandum of Intent and enabling legislation. Our prior advice and the conclusions set forth in this response have been guided by two basic policy objectives: 1) that the sale of Conrail should not provide the purchaser with Federal income tax benefits that would not be available in an analogous transaction between private parties; and 2) that the Internal Revenue Service (the "IRS"), in its role as administrator of the Federal income tax laws, should not be prevented by the sales agreement or enabling legislation from treating Conrail in the same manner as it would any other taxpayer. Based on our analysis of the Memorandum of Intent and the enabling legislation, we believe that the proposed sale is basically consistent with these policy objectives.

Background

Section 401 of the Regional Rail Reorganization Act of 1973 enacted by the Northeast Rail Service Act of 1981 directed the Department of Transportation to devise a plan for returning Conrail to the private sector, preferably by sale of common stock rather than by a sale of its assets. Under current law there are significant differences in the Federal income tax treatment of a sale of stock and a sale of the assets of a corporation. In general, a purchaser of the stock of a corporation receives a tax

basis in the stock purchased equal in amount to the consideration paid for such stock. Other than this change in tax basis for the stock purchased, the sale of stock of a corporation generally does not trigger tax consequences either to the purchaser or to the corporation whose stock is sold. Accordingly, the existing tax attributes of the acquired corporation generally remain intact even though the corporation is owned by different persons.

Carry Over of Tax Attributes

Given the treatment of stock purchase transactions under current law, if the proposed sale of Conrail stock occurred between private parties the tax attributes of Conrail, such as its net operating loss carryforwards, investment tax credit carryforwards, and asset tax basis (including the so-called "frozen asset base"), would remain intact following the sale. The tax consequences of the proposed sale of Conrail to Norfolk would depart from this private transaction model in that certain of Conrail's tax attributes would not survive the sale transaction. Thus, pursuant to a closing agreement to be entered into between Conrail and the IRS, Conrail's net operating loss, investment tax credit and other carryforwards would, with certain exceptions, not be available for carryforward to taxable years beginning after the date of sale (hereinafter, the "Closing").* At the same time, other Conrail tax attributes, in particular, Conrail's asset basis, would, as in a private party transaction, carry over to taxable years after the Closing.

We believe the different treatment of Conrail's tax carryforwards on the one hand and its asset basis on the other is appropriate for a number of reasons. Conrail's existing carryforwards arose during the period of the Federal government's ownership and are for the most part attributable to monies invested in Conrail by the Federal government. The same is not true of Conrail's asset basis. Although the assets held by Conrail have changed substantially since its formation in 1976, data provided to us by the Department of Transportation indicates that the aggregate tax basis of its assets (as of December 31, 1983) is roughly equal to what it was at that time. Thus, the proposed transaction would return Conrail to the private sector with substantially the same asset basis as at the time the Federal government acquired it.**

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* The closing agreement would also provide that Conrail's taxable year would terminate as of the Closing.

** If the effects of inflation are accounted for, Conrail's current asset basis is, of course, much less than at the time of its formation. Moreover, since the value of Conrail's assets today likely exceeds their value at the time of Conrail's formation, the built-in loss in its assets (i.e., the excess of their basis over value) is likely smaller today than it was at Conrail's formation.

We, of course, recognize that the purchase price in a sale transaction will reflect the extent to which advantageous tax attributes carry over in an acquisition. Where the Federal government is the seller, however, any gain in purchase price from a carry over of favorable tax attributes must be weighed against future revenue losses attributable to the purchaser's utilization of the tax attributes. This weighing is more difficult to the extent the purchaser's ability to use the attributes is uncertain. In this respect, the value of Conrail's carryforwards is inherently more speculative than the value of its asset basis, since the carryforwards would be of future value only to the extent that annual depreciation deductions generated by Conrail's asset basis had already been fully utilized. It would thus appear reasonable for the Federal government to require the termination of Conrail's carryforwards rather than speculate as to their value, while, in accord with the model of a private transaction, permitting Conrail to return to the private sector with its asset basis intact.

It should also be noted that the treatment of Conrail's tax attributes in the proposed sale is similar to what was approved by Congress at the time of Conrail's formation. Thus, legislation adopted in connection with Conrail's formation, now reflected in section 374(c) of the Internal Revenue Code (the "Code"), provided that the net operating loss carryforwards of Conrail's predecessors would not carry over to Conrail whereas Conrail would inherit its predecessors' asset basis. The tax consequences of the proposed sale of Conrail would generally conform to that legislative precedent.

Finally, the carry over of Conrail's asset basis should not cause a reduction in Federal income tax revenues collected from Conrail. Although Conrail is a taxable entity, it has not previously paid Federal income tax, nor would it in the foreseeable future given its substantial carryforwards and the high basis in its assets. Because Conrail's carryforwards would not survive the proposed sale to Norfolk, the transaction would, if anything, accelerate the point at which Conrail would become a taxpaying corporation.

Utilization of Conrail Deductions By Norfolk

The proposed sale transaction could adversely affect Federal income tax revenues if future deductions generated by Conrail's asset basis could be utilized to offset otherwise taxable income of Norfolk. As an includible member in Norfolk's consolidated return, tax losses of Conrail could currently offset taxable income of any other member in the consolidated return unless such losses were limited under the separate return limitation year

("SRLY") and the built-in deduction rules of the consolidated return regulations. These rules, in general, prevent the utilization of an acquired corporation's pre-acquisition losses (including losses attributable to assets with tax basis in excess of fair market value, so-called "built-in deductions") against income of any member of the acquiring group. It is conceivable that Norfolk would seek to avoid these restrictions through any of the following strategies: by satisfying the so-called _de minimis_ exception to the SRLY and built-in deduction rules, by transferring assets to Conrail, the income from which would be absorbed by Conrail losses, or by merging Conrail into Norfolk (or an affiliated corporation) in a transaction in which Conrail's tax attributes would carry over.

The consolidated return regulations would provide an exception to the SRLY and built-in deduction rules, if, on the acquisition date, the aggregate of the adjusted tax basis of all assets of Conrail (other than cash, marketable securities, and goodwill) do not exceed the fair market value of such assets by more than 15 percent. See Treas. Reg. § 1.1502-15(a)(4)(i)(_b_). A review of Conrail's tax data, provided to us by the Department of Transportation, suggests that Conrail would not satisfy the _de minimis_ exception, since its aggregate tax basis appears to exceed $3 billion, and Norfolk is paying only $1.2 billion for 85 percent of Conrail's common stock. The _de minimis_ exception, however, is based on the fair market value of Conrail's assets rather than the value of Conrail's stock. Since we do not have appraisals or other direct information concerning the fair market value of Conrail's assets, it is not certain that Conrail would not satisfy the _de minimis_ exception.*

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* Paragraph 12(e) of the Memorandum of Intent provides that as a condition to Norfolk buying Conrail from the Federal government, Norfolk shall have received (at the Federal government's sole election) either a ruling or a warranty that amounts paid to employees of Conrail for services rendered after Closing in order to increase their post-Closing wages to industry standard and the costs paid or incurred for certain routing concessions which are otherwise ordinary and necessary business expenses shall not be treated as built-in deductions and can be deducted when accrued or paid. Although the SRLY and built-in deduction rules apply to amounts economically accrued but not yet deducted, the above expenses do not appear to constitute built-in deductions. Because of the condition that such expenses must otherwise be ordinary and necessary business expenses, the ruling or warranty required by the above condition does not warrant the deductibility of such amounts; only that such amounts are not built-in deductions.

Norfolk's ability to avoid the SRLY and built-in deduction rules by either transferring assets to Conrail or by merging Conrail into Norfolk or an affiliate would be constrained by Norfolk's contractual obligations, by practical business considerations and by the provisions of the tax law. Paragraph 12(b)(iii) of the Memorandum of Intent appears to prohibit a merger of Conrail into Norfolk (or an affiliated corporation) for at least five years after the Closing. In addition, it is questionable whether Norfolk would transfer significant income producing assets to Conrail given that, as reflected in Paragraph 12(b) of the Memorandum of Intent, there would be significant restrictions on Norfolk's ability to withdraw assets from Conrail. With regard to tax law limitations, a transfer of significant assets to Conrail or a merger of Conrail into Norfolk (or an affiliated corporation) could subject future use of Conrail deductions to challenge under section 269 of the Code. See Treas. Reg. § 1.269-3(b)(1).

Warranty of Asset Basis

As provided in Paragraph 6(e)(ii) of the Memorandum of Intent, the Federal government would warrant to Norfolk that the asset basis reflected on Conrail's tax return for the year ending on the Closing would not be decreased as a result of an audit adjustment for a taxable year ending on or before the Closing. We believe this warranty is appropriate for a variety of reasons. Most importantly, the warranty protection extended to Norfolk is consistent with the allocation of risks that could be expected in an analogous private party transaction. Conrail has not been audited since its formation and its tax basis in many assets would have to be traced to its predecessors. As a consequence, Norfolk has no effective means of determining whether Conrail's asset basis is accurately reflected on its tax returns. In circumstances where the accuracy of the selling party's tax accounting cannot be established, it is reasonable to expect the seller to retain the risk of audit.

Consistent with the above warranty, Paragraph 6(e)(iii) and (iv) of the Memorandum of Intent require the Federal government to warrant that the adjusted tax basis of Conrail's assets would not be reduced and no gain or loss or income would be recognized by Conrail or Norfolk as a result of the sale of Conrail's stock to Norfolk, except in the event Norfolk makes, or is deemed to have made, an election under section 338 of the Code. If a section 338 election were made (or deemed made) by Norfolk in connection with its purchase of the stock of Conrail, Conrail would be treated as if it sold all of its assets to itself in a liquidating sale, and the tax basis of its assets would be adjusted to an amount based upon the amount Norfolk paid for Conrail's stock (grossed-up to reflect a purchase of 100 percent of Conrail's stock). The Memorandum of Intent further provides

that, for purposes of the warranty, Norfolk would not be deemed to make a section 338 election as a result of any asset acquisition provided that Norfolk (and its affiliates) elect either to treat such assets acquired in accordance with regulations promulgated under section 338 or elect under conditions to be agreed upon that the basis of such assets would not exceed the transferor's basis in the assets immediately before the acquisition. This warranty was provided because, as of the date the Memorandum of Intent was signed, the regulations providing for a carryover basis to avoid a deemed election under section 338, contemplated by Congress in the Tax Reform Act of 1984, had not been issued.

It should be noted that the warranty protection that Norfolk receives is not a guarantee that the IRS will not audit Conrail for pre-Closing years or that if it does so that it will not be entitled to require a reduction in Conrail's asset basis. In the event of an IRS audit and resultant reduction in basis, the warranty procedure contemplated in the Memorandum of Intent and enabling legislation entitles Conrail to sue in Federal court and to obtain a judgment which could be applied to offset any increase in tax liability attributable to the basis reduction. Although this procedure leaves Conrail economically protected from the risk of audit, it does not otherwise impair the IRS' ability to conduct an audit of Conrail. Retention of the IRS' audit authority with respect to Conrail's pre-Closing years could be significant to the extent substantive tax issues relating to those years have relevance to issues arising in other tax years of Conrail or to the administration of the Federal income tax system generally.

Change in Methods of Depreciation

The potential value of any built-in loss in Conrail's assets also depends on the period of time over which those assets would be depreciated. The warranty as to asset basis provided in Paragraph 6(e)(ii) of the Memorandum of Intent contains a condition that the depreciation of such assets should be determined without extraordinary departures from the methods of prior years. In general, since a depreciation method is considered a method of accounting, a taxpayer cannot change its method of depreciation with respect to a particular asset without first obtaining permission from the Commissioner of the IRS.* In this regard, Conrail and Norfolk would be treated the same as any other taxpayer if, after the sale of Conrail, a change in depreciation method were requested.

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* Section 203(c) of the Economic Recovery Tax Act of 1981 permitted taxpayers to change their method of depreciating railroad track without having such change treated as a change in method of accounting. It does not appear that this provision applies to a change in the method of depreciating railroad track initiated after 1981. Thus, Conrail should not be able to change its present method of depreciating its "frozen asset base" without securing the prior approval of the IRS.

Carry Over of Earnings & Profits

At present, Conrail may have a deficit earnings and profit account reflecting its substantial net losses over the period of its operation.* The Memorandum of Intent does not directly state whether the earnings and profits history of Conrail would carry over to post-Closing taxable years. Since earnings and profits ordinarily would carry over in a stock acquisition, the failure to state a contrary result suggests that Conrail's earnings and profits account would survive the transaction. Since earnings and profits are a measure of a corporation's income or loss, it would seem that Conrail's earnings and profits should be treated consistently with Conrail's net operating losses, and thus should not carry over to post-Closing years. We thus believe that a definitive sale agreement should clarify the treatment of Conrail's earnings and profits by providing that they not carry over in the sale transaction.

The value to Norfolk of a carryover of Conrail's earnings and profits is uncertain. Earnings and profits determine the extent to which a corporation's distributions to its shareholders are dividends rather than a return of capital. Although a deficit earnings and profits account would permit a corporation to make nontaxable return of capital distributions to its shareholders,** Conrail will be a wholly-owned member of Norfolk's consolidated group and thus its distributions will be nontaxable whether characterized as dividends or as a return of capital. We understand that Norfolk itself has a substantial surplus in its earnings and profits, and thus any distributions by Norfolk to its shareholders would be fully taxable dividends even if they were attributable to distributions from Conrail. Moreover, Norfolk's surplus in earnings and profits would not be offset by any deficit of Conrail even if Conrail were to merge with Norfolk. See section 381(c)(2) of the Code.

Cancellation of Conrail Debt and Preferred Stock

The Northeast Rail Service Act, which directed the Department of Transportation to devise a plan for the sale of Conrail, also directed that Conrail be sold free of the Federal government's

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* We have not been provided any data on Conrail's earnings and profits. There may be uncertainty as to the exact amount because of the uncertain effects of prior law.

** A carryover of any Conrail deficit in earnings and profits could well be disadvantageous to Norfolk, since it would limit Conrail's ability to issue new preferred stock to outside interests. The market for such preferred stock is predominantly among corporations, for whom dividend distributions are more advantageous than returns of capital.

existing debt or preferred stock interests. The apparent intent of the legislation was that Conrail be returned to the private sector with a sound capital structure. This intention is reflected in Paragraph 3 of the Memorandum of Intent, which provides that prior to the sale, approximately $850 million of outstanding Conrail debt, including accrued interest thereon, and approximately $2.3 billion par value of Conrail preferred stock, including accrued and unpaid dividends thereon, held by the Federal government would be "cancelled or retired, and contributed to the capital of Conrail." In addition, under Paragraph 6(e)(i) of the Memorandum of Intent, the Federal government would warrant that Conrail will not recognize income on account of the cancellation of Conrail preferred stock or debt.

Under general tax law principles, reflected in section 61(a)(12) of the Code, a corporation may recognize income where it retires outstanding indebtedness at a cost that is less than the face amount of the indebtedness. This discharge of indebtedness principle recognizes that a taxpayer has an economic profit where it borrows money which it is not required to repay in full. Certain exceptions to the discharge of indebtedness principle are enumerated in section 108 of the Code, including that a corporation does not recognize income where a shareholder contributes indebtedness to the corporation's capital (provided that the shareholder's basis in the debt is not less than the face amount of the debt). This exception, stated in section 108(e)(6), effectively recognizes that any excess of the amount borrowed from a shareholder over the amount repaid might have been directly contributed to the corporation without causing the corporation to recognize income.

Under the substantive principles described above, Conrail would not recognize income from the cancellation of its debt if such cancellation were treated as a contribution to its capital by the Federal government. Although there is little authority addressing whether a shareholder's cancellation of corporate debt is a contribution to capital, characterization of the cancellation of Conrail's debt as a contribution to its capital would seem probable. The cancellation of Conrail's debt would be structured in this form, the cancellation was directed by Congress, and the practical effect of the cancellation would simply be to enhance the value of Conrail common stock owned or controlled by the Federal government.*

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* The Federal government owns approximately 85% of the common stock of Conrail, with the remaining 15% being held by Conrail Equity Corporation ("CEC"), a subsidiary of Conrail (see discussion below under Transactions Involving Conrail's ESOP).

Even if the cancellation of Conrail's debt were not treated as a contribution to its capital by the Federal government, Conrail's carryforwards would remain available to offset any discharge of indebtedness income to Conrail for a pre-Closing year. Given the size of Conrail's carryforwards in comparison to the amount of its outstanding debt, the warranty that Conrail would not recognize discharge income offers additional protection to Conrail only to the extent such income might be recognized after the Closing, i.e., in a year in which the carryforwards would not be available to absorb the income. Although it may be conceivable that the debt cancellation and sale of Conrail could be recharacterized so as to cause Conrail to recognize discharge of indebtedness income after the Closing, any such income would as a practical matter be attributable to the period in which Conrail was owned by the Federal government. We thus believe it is consistent with the other tax consequences of the proposed sale that Conrail be held harmless from any tax liability arising from the cancellation of its indebtedness. A warranty providing for this result is additionally appropriate given that the cancellation is directed by legislation.

The proposed sale agreement also warrants that Conrail will not recognize income from the cancellation of its outstanding preferred stock. Under general tax law principles, a corporation does not recognize income upon a reacquisition or cancellation of its own stock. Thus, absent a recharacterization of the transaction, Conrail should not recognize income from the cancellation of its preferred stock.

Although we are uncertain as to why this warranty was requested, it might conceivably be out of a concern that Conrail's preferred stock could be characterized for tax purposes as indebtedness, and thus that Conrail may recognize income from its cancellation. There is little authority indicating under what circumstances an investment denominated as preferred stock could be recharacterized as debt for tax purposes. We nevertheless view the possibility of such recharacterization in Conrail's circumstances as remote. Recharacterization of any substantial portion of Conrail's preferred stock as debt could push Conrail near or into insolvency.

Transactions Involving Conrail's ESOP

Approximately 15 percent of Conrail's common stock is beneficially owned by Conrail's employee stock ownership plan

("ESOP").* Paragraph 2 of the Memorandum of Intent provides that, at or prior to the Closing, Norfolk or Conrail shall have made appropriate arrangements with respect to the employees of Conrail to accomplish the acquisition by Norfolk of such employees' 15 percent beneficial interest in Conrail. While we understand that separate negotiations between Norfolk and Conrail's employees are still pending, Exhibit A to the Memorandum of Intent indicates that Norfolk proposes to transfer $375 million in cash or Norfolk common stock to Conrail's ESOP.

To the extent that Norfolk's transfer to Conrail's ESOP is in exchange for the ESOP's beneficial interest in Conrail's stock, such amounts would not be deductible contributions by Norfolk but rather costs incurred in acquiring Conrail's stock. On the other hand, to the extent that the amount of Norfolk's transfer to Conrail's ESOP exceeds the value of the ESOP's beneficial interest in Conrail's stock, such amount could be a deductible contribution by Norfolk, subject to the deduction timing rules of Code section 404 (including section 404(j)) and the continued qualification of Conrail's ESOP. The enabling legislation specifically provides that no inference is to be drawn from the provisions of that legislation regarding either the allocation of Norfolk's $375 million transfer between the purchase of Conrail's stock and deductible contributions to the ESOP or the deductibility of any portion of such transfer by Norfolk to Conrail's ESOP.

If the form of Norfolk's arrangements with Conrail's employees were to cause disqualification of Conrail's ESOP, such employees generally would be currently taxable on the value of their beneficial interest in the trust. In this regard,

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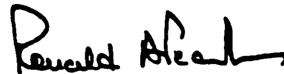
* CEC, all of the common stock and approximately 50 percent of the preferred stock of which is owned by Conrail, currently owns approximately 15 percent of the common stock of Conrail. The other 50 percent of CEC's preferred stock is owned by Conrail's ESOP. Under existing agreements, Conrail's ESOP by 1991 would own 100 percent of CEC's preferred stock which would then be exchanged for the 15 percent of Conrail's common stock held by CEC.

** It should be noted that under Paragraph 12(b)(viii) of the Memorandum of Intent Norfolk and Conrail are prohibited for at least five years from obtaining a reversion of any excess assets held in connection with Conrail's Supplemental Pension Plan. A reversion of plan assets to either Norfolk or Conrail would not be permissible unless and until the plan is terminated and all liabilities of the plan to the employees are fully satisfied.

section 132 of the enabling legislation provides that Conrail's ESOP and related trusts maintained, amended, or adopted in implementing the Secretary of Transportation's plan for the sale of Conrail shall be deemed to meet the qualification requirements of sections 401 and 501, notwithstanding that such plans may not meet the requirements of Code section 415 (which relate to limitations on contributions and other additions with respect to participants in a qualified plan) or that participants in such plans may be entitled to withdraw a portion of the shares allocated to their accounts prior to the expiration of the two-year period generally imposed by the IRS for qualified plans (see Treas. Regs. § 1.401-1(b)(1)(ii)). Although Norfolk's arrangements with Conrail's employees have not been finalized, we believe it appropriate, given the possibly unique form of such arrangements and the unusual structure of Conrail's ESOP, to waive by legislation these two possible technical violations in order that Conrail's ESOP maintain its qualification.

Sincerely,



Ronald A. Pearlman
Assistant Secretary
(Tax Policy)

The Honorable
John C. Danforth, Chairman
Subcommittee on Surface Transportation
Committee on Commerce, Science
and Transportation
United States Senate
Washington, D.C. 20510

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE March 27, 1985

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $5,752 million of $16,006 million of tenders received from the public for the 7-year notes, Series E-1992, auctioned today. The notes will be issued April 2, 1985, and mature April 15, 1992.

The interest rate on the notes will be 11-3/4%. The range of accepted competitive bids, and the corresponding prices at the 11-3/4% interest rate are as follows:

	Yield	Price
Low	11.82% 1/	99.648
High	11.85%	99.508
Average	11.85%	99.508

Tenders at the high yield were allotted 97%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 233,838	$ 18,688
New York	14,097,960	5,137,060
Philadelphia	11,960	11,960
Cleveland	77,718	55,388
Richmond	30,596	19,446
Atlanta	23,839	12,789
Chicago	795,574	262,534
St. Louis	94,815	92,815
Minneapolis	6,941	6,941
Kansas City	38,695	38,682
Dallas	9,131	7,131
San Francisco	579,901	83,561
Treasury	4,995	4,995
Totals	$16,005,963	$5,751,990

The $5,752 million of accepted tenders includes $560 million of noncompetitive tenders and $5,192 million of competitive tenders from the public.

In addition to the $5,752 million of tenders accepted in the auction process, $100 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

1/ Excepting 1 tender of $2,000.

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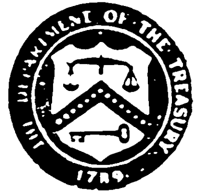
TREASURY NEWS



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FOR RELEASE UPON DELIVERY

March 27, 1985

STATEMENT BY

THE HONORABLE THOMAS J. HEALEY

ASSISTANT SECRETARY OF THE TREASURY

FOR DOMESTIC FINANCE

BEFORE THE

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

Mr. Chairman and members of the Subcommittee:

I am glad to have this opportunity to discuss with you the findings of the "Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services". The recommended reforms, which are based on the principle of regulation by function, are a first step to assigning regulatory responsibility for similar functions to one regulatory entity in order to eliminate overlapping authority. The Task Group's unanimously adopted recommendations were carefully negotiated by the 13 member group and represent a balanced and workable program that is a definite improvement over the current system. Many of the proposals that implement greater functional regulation, especially those that generate little or no controversy such as the centralization of antitrust and securities responsibilities, should be adopted as soon as possible.

As you know, the "Blueprint" does not offer a solution to all the problems in the financial services industry but attempts to strengthen the regulatory system by simplifying it and improving accountability.

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Congress found in the late 1970s that depository institutions could not compete for funds with less restricted financial services firms and thus passed the Depository Institutions Deregulation and Monetary Control Act of 1980. This Act and the Garn-St Germain Act of 1982 authorized the elimination of the federally imposed interest rate ceilings on deposits in commercial banks, savings and loan associations and mutual savings banks. In addition, these Acts increased the asset powers of depository institutions so that they could invest their market rate deposits at a profit.

In order to maintain safety and soundness and consumer protection in our new deregulated environment, the regulatory structure must provide even more effective examination and enforcement than was necessary when the activities of these institutions were more strictly limited.

The current regulatory structure is exceedingly complex. Seven primary federal regulatory agencies, hundreds of state agencies, and many special purpose organizations share regulatory authority over depository institutions. The regulatory system, which has evolved over the past hundred years, needs some significant restructuring. Currently, there is notable overlapping and duplication in the responsibilities of agencies. For example, two different federal agencies regulate state chartered banks and five different federal agencies handle the antitrust issues and the securities matters involving banks and thrifts. In addition, a single business organization which includes a national bank and a parent holding company is supervised by the Office of the Comptroller of Currency (OCC), the Federal Reserve Board (FRB), and the Securities and Exchange Commission (SEC). Because the financial regulatory agencies are "independent" of direct Executive Branch authority, there is not always an effective mechanism for coordinating the activities of these agencies and this impairs the effectiveness of the regulatory system which in the past has been accused of creating "competition in laxity".

The "Blueprint" recommends major changes in the structure of federal bank regulation to increase efficiency and improve the reliability and flexibility of the system. The major proposals which are listed in the Appendix to this testimony, are designed to lead the regulatory system toward one that will eventually be organized predominantly along functional lines. Under the proposals adopted by the Task Group no agency would be eliminated, but agency responsibilities would be restructured. In addition, there are recommendations to reform the deposit insurance system, transfer more responsibility to state regulatory agencies that meet certain qualifications, streamline controls and eliminate or repeal unnecessary regulations and legislation.

The Vice President's Task Group worked for many months to develop a plan that all the participating agencies could support. In your letter asking Treasury to testify on this matter, you point out that the recommendations involve "trades" of regulatory responsibilities which must be executed in their entirety for the arrangement to remain acceptable to the signatories. Consequently, you feel it important for Congress to have a record of those "trades" whose failure to be executed would make it necessary for the Treasury Department and other agencies to remove endorsement of other recommendations and general principles in the report.

Designating such proposals that we find essential is not possible at this time. We would have to evaluate any changes in the recommendations to determine how they would alter the overall effectiveness of the regulatory structure before we could make any comment.

We feel that it would be counterproductive to indicate any recommendations with which Treasury might not agree or finds "improvable". The whole process of working out a comprehensive restructuring of the system required compromises, give and take among the participating agencies. Any proposed changes in these recommendations would have to be carefully studied to make sure they were acceptable.

The Task Group made no recommendations to change the regulation of credit unions or the structure of the Federal Home Loan Bank system and made no proposals for combining the deposit insurance funds. The Task Group found that banks, savings and loan associations and credit unions still have very different balance sheets and business goals. Legislated deregulation has tended to make the activities available to these institutions similar but overall they are still more dissimilar than similar. Therefore, the recommendations concentrate on restructuring the bank regulatory agencies and addressing the overlapping and duplicating activities of these agencies. Even though the recommendations are somewhat limited in this respect there are about 50 recommendations for legislation that the Task Group believes would strengthen the regulatory structure and make it more efficient. At the same time, however, prudent checks and balances would be maintained to help insure a consistently safe and sound financial system.

The Task Group's recommendations were unanimously adopted. They form a balanced and workable program for reorganizing and streamlining the existing federal financial regulatory system. Therefore, we would prefer that the proposals be considered as a whole.

Nevertheless, if it appears to be necessary to implement the Task Group's recommendations in stages, there are any number of proposals which might be taken as subgroups to be legislated whenever feasible. For example, there could be a bill that repeals outmoded legislation such as the Public Utility Holding Company Act or that eliminates overburdening regulation such as requiring federal approval for branch locations.

Thank you for allowing me to present the Treasury Department's views. I will be glad to answer questions you may have.

Attachment

Appendix

The Major Proposals of the Blueprint for Reform

1. The three existing federal bank regulators would be reduced to two by eliminating the FDIC's role in examining, supervising and regulating state non-member banks. A new "Federal Banking Agency" ("FBA") would be created within the Treasury Department, incorporating and upgrading the existing OCC. This agency would regulate all national banks, while the FRB would be responsible for federal regulation of all state-chartered banks.

2. The regulation of bank holding companies would be substantially reorganized. At present, the FRB regulates all bank holding companies, even though a different agency usually regulates the subsidiary bank(s) of the holding company. Under the new system in almost all cases the agency that regulates a bank would also supervise its parent holding company. This would make it possible for most banking organizations to have a single federal regulator rather than two.

3. The FRB would transfer its authority to establish the permissible activities of bank holding companies to the new FBA, although it would maintain a limited veto right over new activities.

4. The FRB would continue to supervise the holding companies of the very largest domestic banks, as well as those with significant international activities and foreign-owned institutions.

5. The FDIC would be refocused exclusively on providing deposit insurance and administering the deposit insurance system. All its current responsibilities for environmental, consumer, antitrust and other laws not directly related to the solvency of insured banks would be transferred to other agencies, as would its responsibilities for routine examination, supervision and regulation of state non-member banks. At the same time, the FDIC would assume new authority to review issuance of insurance to all institutions, as well as to examine all troubled institutions and a sample of non-troubled firms in conjunction with the primary supervisor. The FDIC would also have new authority to take enforcement action against violations of federal law concerning unsafe banking practices in any bank examined by it where the primary regulator failed to take such action upon prior request of the FDIC.

6. A new program would transfer current federal supervision of many state-chartered banks and S&Ls (and their holding companies) to the better state regulatory agencies, creating new incentives for states to assume a stronger role in supervision.

7. The special regulatory system for thrifts would be maintained, but eligibility would be based on whether an institution is actually competing as a thrift, rather than on its type of charter.

8. The FDIC and FSLIC would be required to establish common minimum capital requirements and accounting standards for insurance purposes.

9. Antitrust and securities matters would each be handled by a single agency rather than five different agencies at present.

10. Some specific regulatory provisions would be simplified to eliminate unnecessary burden. These include existing legislative provisions that encourage wasteful litigation, as well as outdated application requirements in various areas.

federal financing bank NEWS
WASHINGTON, D.C. 20220

Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE March 27, 1985

FEDERAL FINANCING BANK ACTIVITY

Francis X. Cavanaugh, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of February 1985.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $146.6 billion on February 28, 1985, posting an increase of $0.6 billion from the level on January 31, 1985. This net change was the result of increases in holdings of agency debt issues of $0.1 billion and holdings of agency-guaranteed debt of $0.5 billion. FFB made 253 disbursements during February.

Attached to this release are tables presenting FFB February loan activity, new FFB commitments to lend during February and FFB holdings as of February 28, 1985.

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FEDERAL FINANCING BANK

FEBRUARY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
ON-BUDGET AGENCY DEBT					
TENNESSEE VALLEY AUTHORITY					
Advance #431	2/1	$ 200,000,000.00	2/8/85	8.455%	
Advance #432	2/4	435,000,000.00	2/15/85	8.595%	
Advance #434	2/8	385,000,000.00	2/21/85	8.585%	
Advance #435	2/15	40,000,000.00	2/19/85	8.605%	
Advance #436	2/15	375,000,000.00	2/25/85	8.605%	
Advance #437	2/18	20,000,000.00	2/25/85	8.595%	
Advance #438	2/21	375,000,000.00	3/1/85	8.655%	
Advance #439	2/25	375,000,000.00	3/4/85	8.805%	
Advance #440	2/28	120,000,000.00	3/7/85	8.875%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #300	2/4	10,000,000.00	5/3/85	8.605%	
Note #301	2/7	2,100,000.00	5/6/85	8.535%	
+Note #302	2/8	15,000,000.00	5/9/85	8.585%	
Note #303	2/8	650,000.00	4/18/85	8.585%	
+Note #304	2/13	1,369,000.00	5/13/85	8.635%	
+Note #305	2/15	7,205,000.00	5/16/85	8.605%	
+Note #306	2/19	15,000,000.00	5/20/85	8.605%	
Note #307	2/19	610,000.00	5/20/85	8.605%	
+Note #308	2/27	15,000,000.00	5/24/85	8.775%	
+Note #309	2/28	10,000,000.00	5/24/85	8.875%	
AGENCY ASSETS					
FARMERS HOME ADMINISTRATION					
Certificates of Beneficial Ownership					
	2/4	50,000,000.00	2/1/00	11.515%	11.846% ann.
	2/4	25,000,000.00	2/1/05	11.565%	11.899% ann.
	2/19	20,000,000.00	2/1/05	11.755%	12.100% ann.
	2/25	645,000,000.00	2/1/90	11.465%	11.794% ann.
	2/25	120,000,000.00	2/1/95	11.885%	12.238% ann.
	2/25	25,000,000.00	2/1/00	12.025%	12.387% ann.
	2/25	10,000,000.00	2/1/05	12.115%	12.482% ann.
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Botswana 3	2/1	39,952.20	3/10/91	11.075%	
Korea 19	2/4	306,922.00	6/30/96	11.055%	
Greece 15	2/4	3,374,519.20	6/15/12	11.445%	
Malaysia 6	2/4	113,457.75	9/10/87	10.465%	
Malaysia 7	2/4	259,800.00	7/31/91	11.275%	
Malaysia 8	2/4	702,013.25	7/31/91	8.875%	
Peru 10	2/4	635,595.00	4/10/96	11.360%	
Spain 5	2/4	1,202,314.00	6/15/91	11.125%	
Tunisia 16	2/4	5,323,668.19	2/4/96	11.415%	
Spain 8	2/5	16,344,919.76	3/25/96	10.453%	
Turkey 13	2/5	7,480,432.33	3/24/12	11.575%	
Greece 15	2/7	1,003,408.00	6/15/12	11.545%	
Jordan 12	2/7	9,476,221.64	2/5/95	11.125%	
Liberia 10	2/7	187,449.07	5/15/95	11.525%	
Philippines 10	2/7	1,433,873.04	7/15/92	10.884%	
Portugal 1	2/8	641,165.00	9/12/94	11.205%	
Egypt 6	2/11	21,000,000.00	4/15/14	10.653%	

+rollover

FEDERAL FINANCING BANK

FEBRUARY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual	INTEREST RATE (other than semi-annual)
Foreign Military Sales (Cont'd)					
Jordan 12	2/11	$ 6,809,868.00	2/5/95	11.262%	
Egypt 6	2/13	3,241,949.70	4/15/14	11.725%	
Spain 5	2/13	822,704.74	6/15/91	11.235%	
Spain 7	2/13	17,592.00	7/15/95	11.555%	
Turkey 13	2/13	548,090.88	3/24/12	11.665%	
Peru 8	2/13	266,578.33	12/15/88	10.625%	
Peru 9	2/13	65,822.40	9/15/95	11.105%	
Philippines 10	2/13	369,730.82	7/15/92	10.965%	
Somalia 4	2/14	53,560.65	11/30/12	11.565%	
Morocco 13	2/14	173,701.68	5/31/96	11.295%	
Korea 19	2/14	555,935.00	6/30/96	11.135%	
Jordan 11	2/14	400,000.00	11/15/92	10.045%	
Greece 14	2/14	3,757,801.48	4/30/11	11.616%	
Greece 15	2/14	869,996.06	6/15/12	11.555%	
El Salvador 7	2/14	393,886.80	6/10/96	11.515%	
Ecuador 6	2/14	17,240.65	6/20/89	11.045%	
Botswana 3	2/15	296,382.47	3/10/91	11.235%	
Egypt 6	2/15	5,674,408.00	4/15/14	11.615%	
Egypt 6	2/21	1,808,869.50	4/15/14	11.875%	
Turkey 13	2/21	12,782,242.24	3/24/12	11.839%	
Ecuador 8	2/22	291,591.00	7/31/96	11.315%	
Morocco 12	2/22	36,115.00	9/21/95	11.755%	
Jordan 12	2/25	4,690,907.11	2/5/95	11.673%	
Jordan 10	2/28	81,600.00	3/10/92	9.805%	
Greece 14	2/28	775,934.81	4/30/11	12.195%	
DEPARTMENT OF ENERGY					
Synthetic Fuels - Non-Nuclear Act					
Great Plains Gasification Assoc. #131	2/11	8,000,000.00	1/2/86	9.975%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Indianapolis, IN	2/1	3,831,500.00	2/1/90	10.606%	10.887% ann.
*Louisville, KY	2/1	4,330,000.00	2/1/91	10.720%	11.007% ann.
Sacramento, CA	2/1	500,000.00	2/1/92	10.904%	11.201% ann.
Peoria, IL	2/1	5,431,118.53	2/1/88	10.050%	10.303% ann.
Inglewood, CA	2/6	296,078.50	8/1/86	9.695%	9.930% ann.
Santa Ana, CA	2/6	124,500.00	8/15/86	9.735%	9.972% ann.
Lynn, MA	2/13	104,713.75	8/15/85	8.935%	8.939% ann.
*South Bend, IN	2/15	1,213,451.58	2/15/91	10.845%	11.139% ann.
Inglewood, CA	2/20	651,210.19	8/1/86	9.725%	9.961% ann.
Long Beach, CA	2/20	2,000,000.00	8/1/85	8.795%	
Santa Ana, CA	2/20	222,000.00	8/15/86	9.745%	9.982% ann.
Waukegan, IL	2/22	200,000.00	9/1/85	9.185%	9.201% ann.
St. Louis, MO	2/26	750,000.00	2/15/86	9.505%	9.724% ann.
St. Petersburg, FL	2/26	190,000.00	12/1/85	9.345%	9.495% ann.
Santa Ana, CA	2/26	624,700.00	8/15/86	10.065%	10.318% ann.
DEPARTMENT OF THE NAVY					
Ship Lease Financing					
Bobo	2/14	177,137,000.00	4/15/85	8.655%	
+Obregon	2/15	2,063,688.62	4/15/85	8.605%	

*maturity extention
+rollover

FEDERAL FINANCING BANK

FEBRUARY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION					
*Western Farmers Electric #64	2/4	$ 6,000.00	2/4/87	10.175%	10.049% qtr.
Western Farmers Electric #196	2/5	4,720,000.00	2/5/87	10.155%	10.029% qtr.
Western Illinois Power #294	2/6	15,000,000.00	1/2/18	11.465%	11.305% qtr.
Basin Electric #272	2/8	55,000.00	3/31/87	10.242%	10.114% qtr.
Tri-County Electric #284	2/8	2,279,000.00	3/31/87	10.234%	10.106% qtr.
*Wabash Valley Power #104	2/11	3,687,000.00	2/11/87	10.165%	10.039% qtr.
*Wabash Valley Power #104	2/11	3,175,000.00	2/11/87	10.165%	10.039% qtr.
*Wabash Valley Power #206	2/11	602,000.00	2/11/87	10.165%	10.039% qtr.
Central Electric #131	2/11	40,000.00	2/11/87	10.165%	10.039% qtr.
Kansas Electric #282	2/11	1,045,000.00	12/31/15	11.515%	11.354% qtr.
Deseret G&T #170	2/11	294,000.00	2/11/87	10.165%	10.039% qtr.
Deseret G&T #211	2/11	4,915,000.00	2/11/87	10.165%	10.039% qtr.
*Wolverine Power #101	2/11	653,000.00	2/11/87	10.165%	10.039% qtr.
*Wolverine Power #182	2/11	858,000.00	2/10/88	10.535%	10.400% qtr.
*Wolverine Power #183	2/11	1,101,000.00	2/10/88	10.535%	10.400% qtr.
Tex-La Electric #208	2/13	378,000.00	2/13/87	10.195%	10.068% qtr.
Vermont Electric #303	2/13	2,026,000.00	1/2/18	11.550%	11.388% qtr.
*Wolverine Power #100	2/13	983,000.00	3/31/87	10.478%	10.344% qtr.
New Hampshire Electric #270	2/13	453,000.00	3/31/87	10.255%	10.127% qtr.
N.E. Texas Electric #280	2/15	551,000.00	3/31/87	10.167%	10.041% qtr.
Allegheny Electric #255	2/15	2,802,000.00	3/31/87	10.175%	10.049% qtr.
Cajun Electric #263	2/15	70,000,000.00	3/31/87	10.175%	10.049% qtr.
*Wabash Valey Power #252	2/15	1,106,000.00	2/15/87	10.115%	9.990% qtr.
*New Hampshire Electric #192	2/15	915,000.00	2/16/87	10.115%	9.990% qtr.
*S. Mississippi Electric #3	2/15	112,000.00	3/31/87	10.154%	10.028% qtr.
*Basin Electric #137	2/19	15,000,000.00	2/19/87	10.155%	10.029% qtr.
*Dairyland Power #54	2/19	1,960,000.00	2/19/87	10.155%	10.029% qtr.
*San Miguel Electric #110	2/19	4,000,000.00	2/17/88	10.505%	10.371% qtr.
United Power #159	2/20	500,000.00	2/20/87	10.135%	10.010% qtr.
United Power #212	2/20	1,959,000.00	2/20/87	10.135%	10.010% qtr.
United Power #222	2/20	300,000.00	2/20/87	10.135%	10.010% qtr.
Brazos Electric #108	2/21	1,333,000.00	2/21/87	10.265%	10.137% qtr.
Brazos Electric #230	2/21	2,633,000.00	2/21/87	10.265%	10.137% qtr.
Colorado Ute Electric #168	2/21	6,212.00	2/23/87	10.265%	10.137% qtr.
Old Dominion Electric #267	2/22	1,211,000.00	3/31/87	10.471%	10.337% qtr.
*Soyland Power #226	2/22	16,105,000.00	1/2/18	11.799%	11.630% qtr.
*Dairyland Power #54	2/25	9,655,000.00	2/25/87	10.465%	10.332% qtr.
*Basin Electric #137	2/25	20,000,000.00	2/25/87	10.465%	10.332% qtr.
*Colorado Ute Electric #71	2/25	1,720,000.00	2/25/87	10.465%	10.332% qtr.
*Colorado Ute Electric #203	2/25	1,675,000.00	2/25/87	10.465%	10.332% qtr.
*Tex-La Electric #208	2/25	4,950,000.00	1/2/18	11.932%	11.759% qtr.
*Cajun Electric #76	2/26	56,000,000.00	12/31/12	12.008%	11.833% qtr.
Central Power Electric #278	2/27	592,000.00	3/31/87	10.550%	10.414% qtr.
San Miguel Electric #110	2/28	1,110,000.00	3/2/87	10.685%	10.546% qtr.
*Allegheny Electric #93	2/28	3,622,000.00	3/31/87	10.732%	10.592% qtr.
*Basin Electric #232	2/28	4,234,000.00	3/2/87	10.685%	10.546% qtr.
*Oglethorpe Power #246	2/28	24,822,000.00	3/2/87	10.685%	10.546% qtr.
Plains Electric #158	2/28	106,000.00	3/2/87	10.685%	10.546% qtr.
*Tex-La Electric #208	2/28	670,000.00	1/2/18	12.088%	11.911% qtr.
Plains Electric #300	2/28	7,054,000.00	3/31/87	10.735%	10.595% qtr.
Kamo Electric #266	2/28	6,552,000.00	3/31/87	10.747%	10.606% qtr.
Sho-Me Power #164	2/28	750,000.00	3/2/87	10.685%	10.546% qtr.
New Hampshire Electric #270	2/28	247,000.00	3/31/87	10.755%	10.614% qtr.
Basin Electric #272	2/28	7,000.00	3/31/87	10.740%	10.600% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
The St. Louis Local Dev. Co.	2/6	$ 26,000.00	2/1/00	11.431%	
The St. Louis Local Dev. Co.	2/6	26,000.00	2/1/00	11.431%	
Dev. Corp. of Mid. Georgia	2/6	30,000.00	2/1/00	11.431%	
Region Nine Dev. Corp.	2/6	37,000.00	2/1/00	11.431%	
The St. Louis Local Dev. Co.	2/6	38,000.00	2/1/00	11.431%	

*maturity extension

FEDERAL FINANCING BANK

FEBRUARY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
The St. Louis Local Dev. Co.	2/6	$ 70,000.00	2/1/00	11.431%	
E&BDC of Montgomery County, MD	2/6	84,000.00	2/1/00	11.431%	
The St. Louis Local Dev. Co.	2/6	99,000.00	2/1/00	11.431%	
Metro Sm. Bus. Asst. Corp.	2/6	101,000.00	2/1/00	11.431%	
San Diego County L.D.C.	2/6	103,000.00	2/1/00	11.431%	
Detroit Economic Growth Corp.	2/6	140,000.00	2/1/00	11.431%	
Texas Certified Dev. Co., Inc.	2/6	155,000.00	2/1/00	11.431%	
Columbus Countywide Dev. Corp.	2/6	168,000.00	2/1/00	11.431%	
Kisatchie-Delta Reg. P&D Dis.	2/6	168,000.00	2/1/00	11.431%	
Wisconsin Bus. Dev. Fin. Corp.	2/6	179,000.00	2/1/00	11.431%	
Texas Panhandle Reg. Dev. Corp.	2/6	191,000.00	2/1/00	11.431%	
Cascades West Fin. Srvs, Inc.	2/6	193,000.00	2/1/00	11.431%	
Bus. Dev. Corp. of Nebraska	2/6	225,000.00	2/1/00	11.431%	
Concord Regional Dev. Corp.	2/6	268,000.00	2/1/00	11.431%	
Rural Missouri, Inc.	2/6	280,000.00	2/1/00	11.431%	
Toledo Econ. Plan. Cn., Inc.	2/6	500,000.00	2/1/00	11.431%	
Springfield Cert. Dev. Co.	2/6	44,000.00	2/1/05	11.518%	
Detroit Econ. Gr. Corp. L.D.C.	2/6	56,000.00	2/1/05	11.518%	
Cumberland County Bus Dev Corp	2/6	58,000.00	2/1/05	11.518%	
Phoenix Local Dev. Corp.	2/6	65,000.00	2/1/05	11.518%	
Region Eight Dev. Corp.	2/6	68,000.00	2/1/05	11.518%	
The St. Louis County L.D.C.	2/6	79,000.00	2/1/05	11.518%	
Birmingham City Wide L.D.C.	2/6	84,000.00	2/1/05	11.518%	
The St. Louis County L.D.C.	2/6	84,000.00	2/1/05	11.518%	
NGCDC, Inc.	2/6	86,000.00	2/1/05	11.518%	
Cleveland Area Dev. Fin. Corp.	2/6	95,000.00	2/1/05	11.518%	
Texas Cert. Dev. Co., Inc.	2/6	95,000.00	2/1/05	11.518%	
Region Nine Dev. Corp.	2/6	103,000.00	2/1/05	11.518%	
Cen. Ozarks Dev., Inc.	2/6	105,000.00	2/1/05	11.518%	
Evergreen Comm. Dev. Assoc.	2/6	111,000.00	2/1/05	11.518%	
E.C.I.A. Business Gr., Inc.	2/6	122,000.00	2/1/05	11.518%	
New Haven Comm. Inv. Corp.	2/6	126,000.00	2/1/05	11.518%	
Iowa Business Growth Co.	2/6	133,000.00	2/1/05	11.518%	
Ocean State Bus. Dev. Auth, Inc	2/6	137,000.00	2/1/05	11.518%	
C.D.C. of Mississippi, Inc.	2/6	137,000.00	2/1/05	11.518%	
Nine County Development, Inc.	2/6	151,000.00	2/1/05	11.518%	
Wilmington Ind. Dev., Inc.	2/6	153,000.00	2/1/05	11.518%	
Phoenix Local Dev. Corp.	2/6	155,000.00	2/1/05	11.518%	
Prince George's C.F.S.C.	2/6	166,000.00	2/1/05	11.518%	
Hamilton County Dev. Co., Inc.	2/6	179,000.00	2/1/05	11.518%	
Alabama Community Dev. Corp.	2/6	191,000.00	2/1/05	11.518%	
Hamilton County Dev. Co., Inc.	2/6	205,000.00	2/1/05	11.518%	
Long Island Development Corp.	2/6	248,000.00	2/1/05	11.518%	
South Shore Econ. Dev. Corp.	2/6	252,000.00	2/1/05	11.518%	
Central Ozarks Dev., Inc.	2/6	265,000.00	2/1/05	11.518%	
Long Island Development Corp.	2/6	285,000.00	2/1/05	11.518%	
Forward Development Corp.	2/6	290,000.00	2/1/05	11.518%	
Greater Salt Lake Bus. Dis.	2/6	290,000.00	2/1/05	11.518%	
Greater Salt Lake Bus. Dis.	2/6	315,000.00	2/1/05	11.518%	
Greater Salt Lake Bus. Dis.	2/6	315,000.00	2/1/05	11.518%	
Purchase Area Dev. Dis., Inc.	2/6	317,000.00	2/1/05	11.518%	
Long Island Development Corp.	2/6	340,000.00	2/1/05	11.518%	
Empire State Cert. Dev. Corp.	2/6	340,000.00	2/1/05	11.518%	
S.W. Ill. Areawide Bus. D.F.C.	2/6	364,000.00	2/1/05	11.518%	
Virginia Economic Dev. Corp.	2/6	401,000.00	2/1/05	11.518%	
Evergreen Comm. Dev. Assoc.	2/6	426,000.00	2/1/05	11.518%	
Massachusetts Cert. Dev. Corp.	2/6	500,000.00	2/1/05	11.518%	
CANDO Citywide Dev. Corp.	2/6	500,000.00	2/1/05	11.518%	
Nine County Development, Inc.	2/6	30,000.00	2/1/10	11.545%	
River East Progress, Inc.	2/6	61,000.00	2/1/10	11.545%	
Bridgeport Economic Dev. Corp.	2/6	76,000.00	2/1/10	11.545%	
The St. Louis County L.D.C.	2/6	83,000.00	2/1/10	11.545%	
Chester County S.B.A. Corp.	2/6	87,000.00	2/1/10	11.545%	
San Diego County L.D.C.	2/6	97,000.00	2/1/10	11.545%	

FEDERAL FINANCING BANK

FEBRUARY 1985 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Bay Colony Development Corp.	2/6	$ 99,000.00	2/1/10	11.545%	
Covington First Dev. Corp.	2/6	116,000.00	2/1/10	11.545%	
The Gr. Stark Cty. Gr. Assoc.	2/6	131,000.00	2/1/10	11.545%	
Opportunities Minnesota, Inc.	2/6	137,000.00	2/1/10	11.545%	
Ocean State Bus Dev Auth, Inc	2/6	151,000.00	2/1/10	11.545%	
Warren Redev. & Planning Corp.	2/6	168,000.00	2/1/10	11.545%	
San Diego County L.D.C.	2/6	168,000.00	2/1/10	11.545%	
Evergreen Community Dev. Assoc.	2/6	184,000.00	2/1/10	11.545%	
San Diego County L.D.C.	2/6	197,000.00	2/1/10	11.545%	
Ark-Tex Regional Dev. Co., Inc.	2/6	200,000.00	2/1/10	11.545%	
Wisconsin Bus. Dev. Fin. Corp.	2/6	202,000.00	2/1/10	11.545%	
Opportunities Minnesota, Inc.	2/6	215,000.00	2/1/10	11.545%	
Neuse River Dev. Auth., Inc.	2/6	224,000.00	2/1/10	11.545%	
Advancement, Inc.	2/6	233,000.00	2/1/10	11.545%	
Opportunities Minnesota, Inc.	2/6	267,000.00	2/1/10	11.545%	
Bay Area Bus. Dev. Co.	2/6	334,000.00	2/1/10	11.545%	
Tuscon Local Development Corp.	2/6	382,000.00	2/1/10	11.545%	
Wisconsin Bus. Dev. Fin. Corp.	2/6	428,000.00	2/1/10	11.545%	
C.D.C. of N.E. Georgia	2/6	473,000.00	2/1/10	11.545%	
Bay Area Business Dev. Co.	2/6	500,000.00	2/1/10	11.545%	
Cen California Cert Dev Corp	2/6	500,000.00	2/1/10	11.545%	
Los Angeles LDC, Inc.	2/6	500,000.00	2/1/10	11.545%	
Empire State Cert. Dev. Corp.	2/6	500,000.00	2/1/10	11.545%	
Railbelt Comm. Dev. Corp.	2/6	500,000.00	2/1/10	11.545%	
Small Business Investment Company Debentures					
Crocker Capital Corp.	2/20	200,000.00	2/1/90	11.105%	
First Oklahoma Inv. Cap. Corp.	2/20	1,500,000.00	2/1/90	11.105%	
Marwit Capital Corporation	2/20	1,000,000.00	2/1/90	11.105%	
Western Financial Cap. Corp.	2/20	1,000,000.00	2/1/90	11.105%	
Advent Industrial Cap. Co., LP	2/20	2,500,000.00	2/1/92	11.445%	
Advent V Capital Company, LP	2/20	20,000,000.00	2/1/92	11.445%	
NYBDC Capital Corp.	2/20	150,000.00	2/1/92	11.445%	
BT Capital Corporation	2/20	5,000,000.00	2/1/95	11.505%	
Cap. Corp. of Wyoming, Inc.	2/20	200,000.00	2/1/95	11.505%	
Clinton Capital Corporation	2/20	3,000,000.00	2/1/95	11.505%	
Edwards Capital Company	2/20	1,500,000.00	2/1/95	11.505%	
Fundex Capital Corporation	2/20	480,000.00	2/1/95	11.505%	
MVenture Corporation	2/20	4,200,000.00	2/1/95	11.505%	
Metropolitan Venture Co, Inc.	2/20	1,000,000.00	2/1/95	11.505%	
NYBDC Capital Corporation	2/20	350,000.00	2/1/95	11.505%	
TLC Funding Corporation	2/20	1,044,000.00	2/1/95	11.505%	
UST Capital Corporation	2/20	1,500,000.00	2/1/95	11.505%	
Unicorn Ventures, Ltd.	2/20	2,500,000.00	2/1/95	11.505%	
Walnut Street Capital Corp.	2/20	1,500,000.00	2/1/95	11.505%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-85-05	2/28	549,301,538.81	5/31/85	8.785%	

FEDERAL FINANCING BANK

FEBRUARY 1985 Commitment

BORROWER	GUARANTOR	AMOUNT	EXPIRES	MATURITY
Jersey City, N.J.	HUD	$25,000,000.00	10/1/86	10/1/91

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	February 28, 1985	January 31, 1985	Net Change 2/1/85-2/28/85	Net Change--FY 1985 10/1/84-2/28/85
On-Budget Agency Debt				
Tennessee Valley Authority	$ 13,950.0	$ 13,810.0	$ 140.0	$ 515.0
Export-Import Bank	15,852.2	15,852.2	-0-	162.3
NCUA-Central Liquidity Facility	288.6	286.2	2.4	19.7
Off-Budget Agency Debt				
U.S. Postal Service	1,087.0	1,087.0	-0-	-0-
U.S. Railway Association	51.3	51.3	-0-	-0-
Agency Assets				
Farmers Home Administration	59,041.0	59,066.0	-25.0	-470.0
DHHS-Health Maintenance Org.	112.9	115.7	-2.8	-3.2
DHHS-Medical Facilities	132.0	132.0	-0-	-0-
Overseas Private Investment Corp.	8.3	8.3	-0-	-2.7
Rural Electrification Admin.-CBO	3,536.7	3,536.7	-0-	-0-
Small Business Administration	37.0	37.6	-0.6	-3.1
Government-Guaranteed Lending				
DOD-Foreign Military Sales	17,506.6	17,404.8	101.8	395.7
DEd.-Student Loan Marketing Assn.	5,000.0	5,000.0	-0-	-0-
DOE-Geothermal Loan Guarantees	11.8	11.8	-0-	5.6
DOE-Non-Nuclear Act (Great Plains)	1,436.0	1,428.0	8.0	146.0
DHUD-Community Dev. Block Grant	243.2	239.2	4.0	35.0
DHUD-New Communities	33.5	33.5	-0-	-0-
DHUD-Public Housing Notes	2,146.2	2,146.2	-0-	-32.3
General Services Administration	411.3	411.3	-0-	-2.0
DOI-Guam Power Authority	36.0	36.0	-0-	-0-
DOI-Virgin Islands	28.3	28.3	-0-	-0.4
NASA-Space Communications Co.	902.3	902.3	-0-	-52.3
DON-Ship Lease Financing	643.5	521.3	122.2	643.5
DON-Defense Production Act	4.0	4.0	-0-	0.9
Rural Electrification Admin.	20,804.1	20,652.5	151.6	217.0
SBA-Small Business Investment Cos.	920.3	880.7	39.6	60.0
SBA-State/Local Development Cos.	466.3	448.4	17.9	111.7
TVA-Seven States Energy Corp.	1,588.2	1,570.5	17.7	32.7
DOT-Section 511	155.5	155.6	-0-	-4.1
DOT-WMATA	177.0	177.0	-0-	-0-
TOTALS*	$ 146,611.1	$ 146,034.3	$ 576.8	$ 1,775.0

*figures may not total due to rounding

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

ADDRESS BY
THE HONORABLE DAVID C. MULFORD
ASSISTANT SECRETARY OF THE
U.S. DEPARTMENT OF THE TREASURY
BEFORE
THE TWENTY-SIXTH ANNUAL MEETING
OF THE INTER-AMERICAN DEVELOPMENT BANK
VIENNA, AUSTRIA
MARCH 26, 1985

Mr. Chairman, President Ortiz-Mena, Fellow Governors, Ladies and Gentlemen, I would like to begin by expressing on behalf of the entire United States delegation our pleasure these past few days in accepting the warm and very gracious hospitality of beautiful and historic Vienna. A year ago we met in lovely Punta Del Este, where the focus was on the international debt crisis. Today, we meet in a different hemisphere, but also in a changed atmosphere, joined together by our common interest in economic growth and development. I hope in our present discussions on the role of the Bank in a rapidly changing global economic environment, we can draw creatively on our past experiences in order to forge a better understanding of how we can jointly achieve our growth and development objectives for the future.

Before turning to my remarks, I would like to extend the best wishes of Secretary of the Treasury, James A. Baker who will soon become the new U.S. Governor of the Inter-American Development Bank. Secretary Baker has asked me to congratulate you on the progress made towards establishing the Inter-American Investment Corporation. This important cooperative effort to encourage investment within our hemisphere has now very nearly become a reality.

Much has changed since Punta Del Este to alter the focus of our attention. At last year's IDB annual meeting, many of us here participated in a special session to discuss the international debt issue. In October, at the IMF/World Bank meetings, the United Sates took the initiative in proposing another special meeting -- this time at the Interim and Development Committee meetings next month in Washington -- to continue and to expand this dialogue. The focus in April will be on the wide range of elements which are involved in the restoration of sustained growth, including of course problems of indebtedness.

We in the United States are confident and optimistic about the prospects for world growth. President Reagan expressed the essence of our present view in his speech at the World Bank meeting in September. He said that three years earlier he had asked, "that we examine the terrible shocks inflicted upon the world economy during the 1970s, that all of us face up to the origins of those problems, and also recognize our ability to withstand and surmount them."

He went on to say, "one conclusion seemed both undeniable and universally true. The societies whose economies had fared best during these tumultuous times were not the most tightly controlled, not necessarily the biggest in size, nor even the wealthiest in natural resources. What united the leaders for growth was a willingness to trust the people -- to believe in rewarding hard work and legitimate risk."

Progress in the Industrial Countries

All of our nations have been living through a prolonged period of major change in the world economy, marked by a difficult but essential transition from inflationary domestic policies to more sustainable growth for the longer term. Many countries, including my own, are now emerging from their most severe economic contraction in two decades. Others, while maintaining modest economic growth, have nevertheless been forced to adjust domestic economic policies and to adapt to external developments in order to sustain growth for the future.

Some of us have been able to make considerable progress toward our objectives. Others are still in the early stages of adjusting to external change. But we all have more work ahead of us.

Through major domestic policy changes, the industrial countries of Europe, Japan, and North America, have sought to quell inflation and to put in place the foundations for stable growth -- a challenge at any time, but especially in the wake of the radically altered economic environment of the 1970s.

In Europe, efforts to reduce the role of government in the economy are coinciding with accelerating and more widely shared growth, nurtured by a sharp recovery in export markets, particularly that of the United States. Collective GNP growth for Europe should approach 3 percent this year -- and perhaps more, if capital and labor become more mobile. For the longer term, however, Europe appears to be recognizing increasingly that it needs to address a number of what we refer to as domestic structural rigidities, including those designed to benefit individual workers, which in the aggregate unfortunately hamper economic growth and reduce the common welfare.

The Japanese economy continues its solid record of sustained advances. Its growth rate of nearly 6 percent in 1984 has been led primarily by increased exports. Growth in 1985 is expected to continue at a more sustainable level of 5 percent and should be more balanced, with better growth in domestic sectors of the economy. The international economy should benefit from this improvement, but would benefit more if access to Japanese markets were also to improve.

Canada, after enduring protracted inflation and stagnation, has achieved a strong recovery with lower inflation last year and is beginning efforts to allow private business greater opportunities to harness the bountiful potential of that country.

But it is the United States that has provided the major impetus for growth worldwide. In a marked departure from more than a decade of disappointing economic performance, and the widespread perception that we could not anticipate any early return to the rapid rates of growth experienced in the 1960s, U.S. growth has, in fact, been sustained at a strong rate of 6 percent since the low point of our recession in 1982. We have sharply reduced the rate of inflation to a current rate of less than 4 percent. Interest rates have been cut nearly in half from their previous high of about 20 percent, and the recent decline in real rates. In short, a new dynamism has been restored to the private sector.

Since 1982, the U.S. economy has created over 7.5 million jobs -- almost all in the private sector. We now anticipate a more sustainable four percent growth rate for 1985 and beyond, with a well-founded expectation of further declines in inflation.

In this environment, we may forget too easily what appeared in the 1970's to be an attitude of resignation to low growth and a high "embedded rate of inflation." President Reagan has provided confident leadership and a firm commitment to the removal of regulatory restrictions on the private sector, as well as policies to reduce taxation. Money supply growth has been steadier. These policies, taken together, have transformed our performance, as well as our expectations. Our success in reducing inflation and in restoring strong economic growth have inspired widespread confidence and optimism in the U.S. economy, both within the United States and abroad.

I readily acknowledge that there are still potential risks in the U.S. economic outlook. Interest rates still remain high by historical standards. Our large budget deficit is a matter of considerable concern, and growing trade deficits have spurred protectionist pressures which are becoming increasingly difficult to withstand. We still have much work ahead of us, and are now engaged in a major struggle to reduce federal deficits. To demonstrate his commitment to this effort, President Reagan recently vetoed politically sensitive farm legislation which would have significantly increased Government expenditures. We are fully prepared to put our own trade restrictions on the line as part of a multilateral commitment to new trade negotiations in order to liberalize trade in the interest of all nations.

The lesson of these developments is clear: adjustment can be, and often is painful, but concentrated efforts can produce dramatic results in a very short time. Failure to address the need for adjustment, on the other hand, will not alleviate the pain, but merely make it more pronounced and disruptive over the longer term.

Latin America and the Caribbean

The experiences in Latin America and the Caribbean over the last four years may portend a similar evolution. Some difficulties have been surmounted, but many remain.

We are all very much aware of the painful shock forced upon the people of our hemisphere after years of seemingly inexhaustible foreign credit. Adjustment to that shock is at least partially behind us.

Now, we see that for Latin America as a whole, a growth rate of 2.5 percent emerged last year. This is a welcome contrast to the two previous years of decline and, I believe, a harbinger of better growth in the years to come.

Looked at from the external standpoint, the decline in the regional current account deficit from $42 billion in 1982 to about $6 billion last year, clearly means the overall financial situation is now more manageable.

Aggregate figures for the region, however, disguise individual country situations. Here, we are sensitive to the fact that so far only a few have done well, many more are midway along the path of resumed growth, and some are still in the early phase of establishing sustained growth. We all clearly have much work to do.

The industrial countries -- especially, in Europe and Japan -- must concentrate on opening their markets and we must all move together toward more liberal trade. I have already referred to the task we face in the United States.

Economic adjustment and renewed confidence are the essential underpinnings for revived flows of direct investment and for the return of capital from abroad.

Commercial banks must give greater consideration to their role in providing new credit to countries which are performing well under economic adjustment programs. This is a critical feature of the international debt strategy embraced by the Summit countries. We are concerned about a pattern of bank commitments which suggests that where smaller countries are making the necessary adjustments leading to re-establishment of growth, certain banks appear not to recognize this progress and are unwilling to provide new financing.

The Multilateral Development Banks -- especially, the IDB, our central concern today -- must measure their effectiveness in terms of the contribution they make to helping countries lay the foundation for long term economic growth.

Inter-American Development Bank

Let us now turn to look more closely at the IDB. This year marks the end of the first quarter century of IDB operations throughout Latin America and the Caribbean. The IDB has an impressive record of accomplishments. It is a milestone that deserves our attention and applause. It is also an ideal opportunity to reappraise the efforts we have made over the years.

Budgetary resources are scarce. This is a fact of life that the IDB must face. It therefore has a special obligation to refocus its programs to make efficient use of limited resources. We are doing this in the United States in our current budgetary process and I can personally attest to the fact that it is no easy enterprise. Among the many areas being scrutinized in our budget, we have sought a more efficient use of resources in all the MDBs.

Indeed, this effort began in 1981, when the Reagan Administration first took office. At that time, we made a comprehensive assessment of U.S. participation in the Multilateral Development Banks. The resulting assessment, published in February, 1982, was regarded by the U.S. Government as a blueprint for action -- a summary, if you will, of what we believed must be accomplished in the MDBs over the next few years.

The report expressed the Administration's strong support for the MDBs -- including the IDB -- as effective institutions through which the United States seeks to foster efficient development for the people of the borrowing member countries. The Reagan Administration continues to hold that view.

However, the report also found too much emphasis on the quantity of funding instead of on the quality of the projects being funded. In practice, this focus on quantity has been found wanting. I think every one here understands that now.

The principal change embodied in the assessment was the decision to place more emphasis on market forces, policy reform and sectoral allocation than had been the case previously. In general, it recommended that MDB lending policies provide larger incentives to private sector development. It urged greater selectivity in projects and programs financed by the MDBs, with commensurate flexibility in setting annual lending levels. It called for closer links between lending levels and specific policy reforms that would relate each project to overall development strategy.

In the intervening period, there has been noticeable progress toward these goals in all of the MDBs. Two important changes have been made in the IDB, one in sub-loan interest rates and the other in public utility tariffs. These changes in the IDB policies are encouraging similar changes in these areas in borrowing member countries.

One could say that the process we undertook to adopt these policies has been a confidence building exercise, demonstrating that we are able to make a commitment among ourselves to act on the basis of economic principles. We must build on this base for a more productive future. And we need to begin planning now for that building process to continue.

The United States wants to place greater emphasis on the IDB and the role that it plays in our hemisphere. As members of the IDB, we have an important obligation to the people of the hemisphere to use our resources more effectively. This is not simply a matter of an obsessive attachment to the notion of so-called "conditionality;" rather, it is a matter of vision, good management and results for the people for whom this organization was created.

We might take a further step by making two simple but extremely important reforms in the principles on which we conduct bank business. First, every project that is brought to the Executive Board should be fully justified in economic terms. Regretfully, this has not always been the case. Over the past year, a number of projects were brought forward that we were forced to oppose on purely economic grounds. In some instances, the projects were not well designed. In others, they contravened established policy. Clearly, the Bank's internal project review must be rigorous enough to ensure that such projects do not come to the Executive Board.

Second, we need to help borrowing countries create the economic environment and sectoral policies most conducive for growth and development. Transfer of resources is not enough. Every loan must fit into an appropriate economic policy setting. The IDB must thoroughly analyze the policies of its borrowers and, where necessary, encourage reform before committing its resources. In this respect, the IDB should work to improve its policy coordination and cooperation with other international lenders.

The U.S. Exeuctive Director has already circulated a paper on the advantages to be gained from strengthening the country-programming process. We believe the loan review process can be strengthened by giving greater involvement to offices within the Bank that have sectoral or macro-economic expertise. We may want to require assessments of each

country's sectoral and macro-economic policies in all loan documents and make changes in the organizational structure of the Bank to improve loan quality.

We are not wedded to these specific proposals. Other measures might work as well. What is important, however, is that we work to achieve both the objectives I have identified. This is essential if the IDB is to have a more effective role in encouraging Latin American economic lrowth and development. Frankly, until we make progress in these two areas, it would not be productive for us to discuss financial parameters for future Bank activities.

In the IDB some may suggest that we should simply rewrite the rules or create new or special ways of lending more money. These are not answers to the underlying problems we face.

In policy terms, as applied to the IDB, this means we believe the Industrial Recovery Program and the Special Operating Program have served their purposes and should end, as agreed, in 1985. Similarly, at this point, we are not convinced that either changes in the so-called matrix or Bank financing of non-IDB projects is a solution. Also, while we are willing to discuss the concerns raised by the Central American Governors, we cannot support any modification of the Sixth Replenishment guidelines.

In sum, I appeal to you, as shareholders to evaluate our Bank's performance, retain the policies which are working, reform the policies which are not, avoid the temptation of the easy road and instead take up the challenge I have put before you today. Each of us -- whether donor or borrower, should recognize our own self-interest, as well as the mutuality of our interests within the IDB.

Like all of you, I look forward to the next year's annual meeting. In the meantime, we will stay closely involved with the Bank and hope that a year from now we shall all be able to survey the year with the satisfaction that we have made the IDB a more effective Bank for development in Latin America. We owe that to the people for whom the Bank was created.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE March 28, 1985

RESULTS OF AUCTION OF 20-YEAR 1-MONTH TREASURY BONDS

The Department of the Treasury has accepted $4,261 million of $10,699 million of tenders received from the public for the 20-year 1-month bonds auctioned today. The bonds will be issued April 2, 1985, and mature May 15, 2005.

The interest rate on the bonds will be 12%. The range of accepted competitive bids, and the corresponding prices at the 12% interest rate are as follows:

	Yield	Price
Low	12.00%	99.920
High	12.05%	99.545
Average	12.04%	99.620

Tenders at the high yield were allotted 98%.

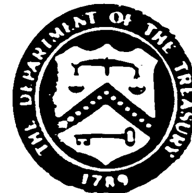
TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 290,524	$ 524
New York	9,170,478	3,889,418
Philadelphia	890	890
Cleveland	24,513	14,513
Richmond	5,889	5,889
Atlanta	10,391	4,391
Chicago	625,204	172,204
St. Louis	64,644	64,639
Minneapolis	4,020	4,000
Kansas City	15,252	15,252
Dallas	458	458
San Francisco	485,849	88,109
Treasury	404	404
Totals	$10,698,516	$4,260,691

The $4,261 million of accepted tenders includes $329 million of noncompetitive tenders and $3,932 million of competitive tenders from the public.

B-65

TREASURY NEWS



epartment of the Treasury • Washington, D.C. • Telephone 566-204

For Release 10:15 a.m.
March 29, 1985

Contact: Brien Benson (566-2041)
Ken Butler (Bureau of Public Debt) 376-4306

SECRETARY BAKER ANNOUNCES SAVINGS BOND REDESIGN

Treasury Secretary James A. Baker, III, today announced a newly designed face for the popular Series EE Savings Bond as part of a gradual shift from punch card to paper bond stock. The design change, which does not affect the terms and conditions of Savings Bonds, will speed up the processing of Savings Bonds, deter counterfeiters, and save over a million dollars a year in printing costs. Additional savings will come from using state-of-the-art equipment in processing bonds.

The Bond face will contain magnetic ink and optical character data that the financial community and Treasury will be able to process and record at high speed with great accuracy.

To deter counterfeiting, the new Bond face will be much more complex. Features will include a gradation of pastel colors from yellow to brown, portraits of Founding Fathers, engraved borders, and a patterned background containing a picture of Independence Hall in Philadelphia.

Lighter paper stock will save $1 million annually once the changeover is fully implemented.

The new format will be introduced in stages during the next two years. Starting in May, all Series EE Savings Bonds produced by Treasury will have the new faces. The change from card to paper will be more gradual. Between May and September, the 96 large payroll agents which inscribe Bonds with computers and report their sales to Treasury using magnetic tape, will convert to paper bonds. These 96 agents issue about half of all Bonds sold each year.

The remaining agents, including over-the-counter and payroll issuers which report sales using hard-copy registration stubs, will receive the newly-designed Bonds in card form until 1987.

By then, the Treasury expects to have equipment that can optically record sales data at high speeds. This capability will allow the completion of the transition to paper. Then the benefits of the design change will come into full force - reduced weight and space requirements, lower shipping costs, and lower stock acquisition costs.

Treasury does not plan to recall Bonds of the old design now held by agents. As the agents use up their old stock, it will be replaced by stock of the new design.

More than 9.5 million Americans buy U. S. Savings Bonds each year, 60 percent of them through payroll savings plans offered by their employers. In 1984, Bond sales totaled $4 billion; nearly $75 billion worth of Bonds are now held by Americans.

To facilitate the introduction of the newly designed bond, Treasury will conduct an awareness program to inform issuing agents and the public about the change.

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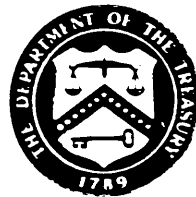
PORTRAITS APPEARING ON NEW DESIGN SERIES EE U.S. SAVINGS BONDS

DENOMINATION	PORTRAIT
$50.00	George Washington
$75.00	John Adams
$100.00	Thomas Jefferson
$200.00	James Madison
$500.00	Alexander Hamilton
$1,000.00	Benjamin Franklin
$5,000.00	Paul Revere
$10,000.00	James Wilson

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR RELEASE UPON DELIVERY

Prepared Remarks by
Secretary of Treasury
James A. Baker, III
at a Press Conference announcing
the new Savings Bond design
Friday, March 29, 1985
Washington, D.C.

Good morning. I'm pleased to announce another step forward in our efforts to modernize Treasury operations and save taxpayer money.

It's a new design for the most commonly used Savings Bond, the Series EE, and the beginning of a shift from card to paper stock. I emphasize that what we are announcing involves <u>no</u> changes in the terms and conditions of the Savings Bond.

The new format will speed up the processing of Savings Bonds, deter counterfeiters, and save over a million dollars a year in printing costs. Additional savings will come from using state-of-the-art equipment in processing bonds.

Although not directly affecting Americans who now hold Bonds, the change will benefit those who buy the $4 billion of new Bonds sold each year.

It will benefit the more than 40,000 U.S. Savings Bonds issuing agents. And it will benefit a Savings Bonds program that has been extremely cost-effective to the U.S. government.

Our design change is similar to the recently announced shift to paper government checks.

By 1987 all Series EE Savings Bonds will be made of multicolored paper, replacing the punched cards used for the last 28 years.

The new Bonds will be more efficient. The Bond face contains magnetic ink and optical character data that the financial community and Treasury will be able to process and record at high speed and with great accuracy.

To deter counterfeiting, the new Bond face will be much more complex. This will include a gradation of pastel colors from yellow to brown, portraits of Founding Fathers, engraved borders, and a patterned background containing a picture of Independence Hall in Philadelphia.

These changes in Savings Bond design are part of Treasury's ongoing effort to increase efficiency and cut costs. In addition to the paper government checks announced earlier this year, Treasury recently introduced the innovative STRIPS program, which not only reduces the cost of debt financing to the government, but offers the public a greater variety of securities.

In addition, Treasury has the lead role in the President's Cash Management reforms, which realized savings of $1.4 billion in fiscal year 1984.

All this was accomplished while reducing staff by 3,000 employees, with a simultaneous increase in productivity.

Now, I want to introduce those who will be involved in the change-over to the new type of Savings Bond.

Fiscal Assistant Secretary Carole J. Dineen, who has overall responsibility for the development and distribution of the new Bond;

Treasurer of the United States Katherine D. Ortega, who is responsible for the public awareness effort and promoting the sale of Savings Bonds;

William M. Gregg, Commissioner of the Public Debt, whose agency will administer the transition;

And Martin French, Assistant Commissioner of the Savings Bond Operations Office, the office that designed the new Bond and which will implement the new design.

PORTRAITS APPEARING ON NEW DESIGN SERIES EE U.S. SAVINGS BONDS

DENOMINATION	PORTRAIT
$50.00	George Washington
$75.00	John Adams
$100.00	Thomas Jefferson
$200.00	James Madison
$500.00	Alexander Hamilton
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$5,000.00	Paul Revere
$10,000.00	James Wilson

The United States and Japan: Their Ad Hoc Agreement and Its Implications

Remarks by Dr. David C. Mulford, Assistant Secretary for International Affairs, U.S. Treasury Department

Euromarkets Conference, London, April 1, 1985

It is a pleasure to be back in London to speak before this distinguished group. April 1 is an auspicious day to discuss the Yen/Dollar Agreement, as today marks the beginning of the next round of liberalization of the Euroyen market. For some of you, April 1st may have other connotations, but I am advised that there is nothing in Japanese history, philosophy, or indeed in MOF regulations, which indicates that April Fool's Day, like other U.S. products, has yet gained access to Japan.

In my remarks today I wish to explain the objectives of the U.S. Treasury in initiating the yen/dollar talks, to touch upon several of their more important results and to close by commenting on some of the Yen/Dollar Agreement's implications for world capital markets.

The United States' concern about the role of the yen in the international financial system was the most important motivation for the yen/dollar discussions. Although it seemed clear to us that the Japanese authorities were not directly depressing the value of their currency, it was equally apparent that the role of the yen in the international financial system did not fully reflect the underlying strength of the Japanese economy.

Japan has become an economic giant, the world's second largest market economy. But the yen has remained the least utilized internationally of all the major industrial nations' currencies. Last year, for example, only some 3-1/2 percent of the world's official reserves were denominated in yen. In trade, Japan uses yen to a much lesser extent than the United States and most European countries use their national currencies. Only about 40 percent of Japan's exports are denominated in domestic currency, compared to 90 percent for U.S. exports and 60-85 percent for the exports of major European countries. On the import side, the figures are a mere 3 percent for Japanese imports denominated in yen, versus 70-85 percent for the United States and 30-45 percent respectively for the currencies of the major European countries. Likewise, in international finance, despite interest in yen assets on the part of many international investors, the yen has been a difficult currency to deploy, and of course, as you all know, there has never been a Euroyen market remotely comparable to other Eurocurrency markets.

We concluded that Japan's financial policies were having an important influence on the value of its currency in international markets. We were also concerned about the broader impact of Japan's policies on the efficiency of the international economic system. If interest rates are not permitted to move freely, or capital flows are discouraged, funds will not be allocated efficiently. This is not simply a matter of domestic concern. In today's highly interdependent world, the policies of one government can be transmitted quickly to the rest of the world, thus influencing the allocation of resources worldwide.

Our general objective, then, was to begin to change the environment in which the exchange rate is determined from one based on government regulation and administrative "guidance" to one governed by market forces. To do this, we believed it was necessary first, to seek full deregulation of Japan's domestic capital market; second, to increase the range and availability of yen-denominated instruments to international borrowers and investors; and third, to improve access to the Japanese market for foreign financial institutions.

The principle objective of domestic deregulation is to allow interest rates to be determined by market forces. This will increase the range and appeal of yen instruments to Japanese and foreign investors alike and help improve efficiency of the resource allocation, both within Japan and between Japan and the rest of the world.

Increasing the access of foreign financial institutions to the Japanese market will ensure not only that foreign investors have access to Japanese assets and that Japan's market becomes more competitive, efficient and innovative, but also that foreign firms actually receive the benefits of "national treatment" in Japan. To accomplish this, there was a need to increase the "transparency" of Ministry of Finance policies, and to improve competitive opportunities for foreign firms (not just U.S. firms) in such areas as trust banking, dealing in Government of Japan securities, and membership on the Tokyo Stock Exchange.

Our chief avenue for near-term progress was the Euroyen market which, though founded in 1971, remained in its infancy. It was, however, a market less encrusted with regulation, compared even to the Samurai market. Hence, the relative lack of legal and market precedents, and the obvious merits of observing established Euromarket formats, caused us to believe that the Euroyen market, and not the Samurai market, offered both the most desirable area for change, as well as the path of least resistance in Japan. Dismantling regulations and controls in Japan's highly structured domestic market, on the other hand, will take more time, but once the process is begun on a sufficient scale, we hope the momentum of change will be to some degree self-perpetuating.

As you know, a major feature of the expanded Euroyen market is the development of a larger and more broadly-based Euroyen bond market. One of the major achievements in our discussions was MOF's decision to open this market in stages to a much greater number of potential issuers. As of today, non-Japanese corporations with ratings of AA or better, and about half of all A-rated firms, will be able to issue Euroyen bonds.

The goal, of course, was and remains to have no restraints or controls on who may issue, but to let the market determine creditworthiness. For AAA, AA and A-rated firms with net worth of ¥600 million or more, the highly restrictive credit criteria imposed by the Ministry of Finance are being replaced this month by internationally accepted credit ratings. We hope MOF will soon abandon the use of credit criteria entirely and allow all potential issuers to issue on the basis of independent ratings.

Japanese corporations, though eligible to issue, have yet to tap the Euroyen market due to the existence of Japanese withholding tax on Euroyen bonds issued by resident companies. However, last week the Diet passed legislation abolishing this tax on bonds held by non-residents, effective today. We are pleased with this important change, which will now allow for greater Japanese sponsorship in the market, but I cannot help but note in passing that just at the time when the United States and other countries have abolished withholding tax on foreign investors, Japan has tightened withholding on the overseas investments of Japanese residents, thereby collecting for itself the revenues formerly collected by the countries which have repealed withholding. Their aim is to discourage the reflow to Japan of Euroyen instruments and, I suppose, to place a damper on capital outflows. While this will not be detrimental to the development of the Euroyen market, it is clearly a backward step for international capital flows and Japan's full integration into world capital markets.

In setting up the Euroyen market, we felt strongly that non-Japanese firms should be allowed to lead and co-lead manage Euroyen issues. This will promote the development of the market by giving foreign investors better access to Euroyen paper and bringing many major Euromarket firms into the important market-making function they perform in other currencies. More competition may also help keep borrowing costs low, a feature of the early rush of Euroyen issues that some of you would probably like to forget. Euroyen certificates of deposits and syndicated Euroyen lending represent two other important beachheads for the market's development.

No summary of the activity in the Euroyen note market is necessary here, as I know you have all been deeply engrossed in the cut and thrust activity of its early months. For the record, however, I would note that there have been 15 Euroyen issues by non-resident corporations since December 1, three of which have had non-Japanese lead managers. In addition, the vast majority

of all Euroyen issues since December 1st have had non-Japanese co-lead managers. I believe most Japanese banks with overseas branches and a number of non-Japanese banks have issued Euroyen CDs. Syndicated lending has been relatively slow, but activity should pick up as the supply of Euroyen funds increases and MOF lifts the one-year maturity limit.

In appraising the implications for the Euroyen market, one must remember it is still at a very early stage of development. For example, it is still subject to some undesirable and, we believe, unnecessary regulation, much of which stems from Japan's Foreign Exchange Control Law. The Ministry of Finance still checks the qualifications of each potential issuer in the Euroyen bond market and requires banks to obtain approval for their first Euroyen CD issue. Various maturity restrictions limit flexibility in funding and lending, and floating rate instruments are not yet available. The lack of Japanese corporate issuers to date and the current inadequacy of Euroyen funding sources are other indications that the market still needs time to develop.

The question is, how long will the Euroyen market remain at this stage of development? Not very long, would be my view. There are simply too many pressures for change. But change does not come quickly in Japan, since there is always the threat of renewed intervention by a government bureaucracy whose penchant is for regulation instead of free markets. Therefore, although I believe the effects of domestic and international financial liberalization in Japan are inexorable, they are also, if you will pardon the expression, inscrutable.

Once some restrictions are lifted, the remaining ones are apt to become more vulnerable. Liberalization in some areas is likely to spawn further change in others. At the moment, for example, the criteria for Japanese residents to issue Euroyen bonds are very restrictive. However, the more liberal criteria for non-residents, plus the ability to swap, allows Japanese corporations to raise Euroyen, even though they may not be able to issue directly. Likewise, Euroyen CDs currently bear fixed rates of interest and must have maturities of six months or less. Nevertheless, the possibility of rollovers makes these Euroyen CDs akin to longer term, adjustable rate instruments.

In addition, official attitudes in Japan are changing. More and more, Japanese officialdom appears to be coming to the conclusion that financial liberalization is inevitable, and even desirable. They are realizing that unless Japan is prepared to cut Japanese corporations off from Eurocurrency borrowing and restrict Japanese foreign investment, it is no longer possible to isolate Japan from international markets. On the contrary, exposure to international financial markets is forcing change on the domestic market through the need for more competitive instruments. Japan's recent capital outflows are simple confirmation of this fact.

Finally, the market opening that has occurred so far has unleashed new competitive pressures for further deregulation. The more aggressive Japanese financial institutions are eager to develop new business. They see some natural advantage in yen transactions and want opportunities in yen that foreign firms have enjoyed in their own markets. Meanwhile, Japanese residents want the same fund-raising possibilities as non-residents, and Japanese investors want investment instruments more accurately reflective of market rates.

As a result, I think it is just a matter of time before we will see more changes in the Euroyen market. Some are already underway. For example, the Ministry of Finance has recently authorized medium and long-term syndicated Euroyen lending to non-residents and is reportedly studying Euroyen bonds with floating rates and shorter maturities. Plans are also afoot to establish an International Banking Facility in Tokyo. This obviously raises the possibility that more Euroyen activity will take place in Japan, but given Japan's regulatory inclinations, I expect that a substantial portion of an expanding Euroyen market will remain offshore. Meanwhile, non-residents' transactions will probably continue to be liberalized more rapidly than residents', but both are likely to continue developing fairly steadily.

So far, I have concentrated on the development of the Euroyen market, but I would like to say a few words about the bearing this has on domestic deregulation in Japan. In many respects, the development of the Euroyen market facilitates the process of domestic deregulation. One reason for this is that, to a large extent, the separation between the two markets is artificial. Japanese residents already have access to other Eurocurrency markets, and companies which cannot issue Euroyen bonds directly have access to yen funds through an active swap market. The removal of the "real demand rule" in April 1984 has also facilitated foreign financial transactions, and competitive arbitrage between the domestic and foreign markets will help integrate the domestic and Euroyen markets.

While the development of the Euroyen market will create strong pressures for deregulation in Japan, there may be a still more effective force for change: Japan's massive capital outflows. In 1984, net recorded capital outflows from Japan were a record $30 billion. Next year, with Japan's growing current account surplus, they will be still higher. Although Japan, with its high savings rate, appears awash in capital, its large public sector budget deficit -- expressed as a share of GNP -- is approximately as large as that of the United States. Japan's high savings rate suggests a potential for higher growth if domestic investment of these savings in Japan were made more attractive.

Meanwhile, to judge by the magnitude of these capital flows, it appears that Japanese investors are behaving like rational investors everywhere, investing, when possible, where the returns to capital are highest. In Japan, it is said that, "The frog in the well knows nothing of the great ocean." It would seem that Japanese investors are now clambering out of the well, and the ocean looks pretty good. Until returns in the domestic market are comparable to those overseas, Japanese investors will probably continue to channel a substantial portion of their savings abroad.

Parenthetically, I might add, these capital outflows suggest that at least in the financial market, Japanese do not necessarily "buy Japan" when alternatives exist. I wonder, then, whether we should accept Japan's protestations, or the views of many foreign businessmen, about the deep-seated desire of Japan's citizens to buy only Japanese goods as an explanation of why Japan's imports of manufactured goods from the outside world are so low. I believe we are correct to look to regulations, formal and informal, as the reason for inadequate access, and I hope Japan will follow in other areas the example it has set in the Yen/Dollar Agreement before irreparable damage is done to the world trading system.

Returning to the capital account, I think the Japanese authorities are likely to have one of two reactions to these developments. One possibility is that they could become sufficiently alarmed by the volume of these outflows to reimpose some form of capital controls. However, such a move would be politically unpalatable for Japan, since it would clearly outrage the rest of the world and certainly violate the spirit, if not the letter, of its understandings with the United States.

I think Japan is more likely to maintain or to increase the pace of domestic deregulation, checking the outflows by improving the returns on investment in Japan. In fact, Japan may already be on this second course. Steps are being considered today that were discussed in our talks last year, but at that time were unacceptable. MOF should be commended for its constructive attitude, for in all our discussions with the Japanese, they have clearly taken steps they perceive to be in their own long-term interests. New steps might include establishing a Treasury bill market, which would provide an attractive short-term instrument for investors and set a market-rate basis for Japan's financial markets. This would also be an important tool for debt management and the execution of monetary policy. Another possibility might be to eliminate withholding taxes on foreign investment in Japan, so as to make investment in Japan more competitive with investment in other markets.

Having said earlier that exchange rate concerns were an important motivation for the yen/dollar discussions, let me say a few words about exchange rate movements since the Yen/Dollar Report was issued last May. At that time, the press,

not perhaps having understood the fundamental nature of the exercise, seeemed to expect that success should be measured by an immediate strengthening of the yen against the dollar. It is true that in the balance of 1984 and early 1985 the yen weakened against the dollar, but we must remember that it has remained stronger against the dollar than any other major currency. As of Friday's New York close, the yen had declined about 7-1/2 percent against the dollar since last May. Over the same period, the DM, French franc and Sterling were all down about 10 to 11 percent against the dollar, while the yen was up some 3 to 3-1/2 percent against these European currencies.

In some respects, the yen's strong performance is not surprising. Japan's economic performance and its sound macro-economic policies surely play an important role. Japan's capital outflows are, of course, a reflection of its large current account surplus. Nevertheless, I think it is very significant that the yen has remained relatively strong in the face of the capital outflows which result from the disparity between the greater freedom to lend or invest abroad and the restrictions in the domestic market. A large portion of these outflows appear to be going into the Euromarket. It may well be that a substantial amount is going into the Euroyen market and remaining in yen-denominated claims, thereby neutralizing, to some extent, the exchange rate effect of Japan's capital outflows. Over time, however, as the domestic and Euroyen markets develop more fully, I think we will be able to state more confidently that Japan's financial market liberalization has helped the yen to reflect more fully the underlying strength of the Japanese economy. And this is what the yen/dollar talks were really all about.

In conclusion, considerable change has occurred in the ten months since the the U.S. Treasury and the Japanese Ministry of Finance released their Yen/Dollar Report. In fact, I think we will look back on this Report as a cornerstone of change, marking the beginning of the internationalization of Japan's financial system. My view, however, is that progress is just beginning. The future pace of Euromarket development depends on a number of factors: the reaction of market participants, including borrowers, intermediaries and most important, investors; conditions in other markets; and internal pressures for further change. However, taking the recent past as a guide, one may safely conclude that the competition in the Euroyen market will be brisk, and the opportunities, great. On the domestic side, growth in the Euroyen market, along with increasing competitive pressures internally and the desire to attract more of Japan's savings for domestic investment, will combine to force more rapid deregulation inside Japan.

I would welcome your comments on my remarks and your suggestions on areas where further liberalization is needed.

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

April 1, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,564 million of 13-week bills and for $ 6,557 million of 26-week bills, both to be issued on April 4, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 5, 1985			26-week bills maturing October 3, 1985		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	8.11%	8.40%	97.927	8.52%	9.03%	95.693
High	8.20%	8.49%	97.904	8.56%	9.07%	95.672
Average	8.18%	8.47%	97.910	8.55%	9.06%	95.678

Tenders at the high discount rate for the 13-week bills were allotted 21%.
Tenders at the high discount rate for the 26-week bills were allotted 60%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 410,245	$ 60,245	$ 401,410	$ 100,710
New York	14,169,120	4,630,970	13,913,380	5,107,380
Philadelphia	32,545	32,545	23,785	23,785
Cleveland	67,855	67,855	42,070	42,070
Richmond	51,680	51,680	72,485	67,685
Atlanta	49,080	49,080	58,105	55,305
Chicago	1,092,690	357,390	1,046,095	294,095
St. Louis	107,995	82,995	95,020	61,020
Minneapolis	34,390	34,390	40,930	40,930
Kansas City	59,730	59,730	67,295	67,295
Dallas	50,195	50,195	35,540	28,540
San Francisco	1,156,940	752,700	1,137,570	275,570
Treasury	333,825	333,825	392,640	392,640
TOTALS	$17,616,290	$6,563,600	$17,326,325	$6,557,025
Type				
Competitive	$14,716,645	$3,663,955	$14,379,920	$3,610,620
Noncompetitive	1,258,535	1,258,535	1,137,105	1,137,105
Subtotal, Public	$15,975,180	$4,922,490	$15,517,025	$4,747,725
Federal Reserve	1,321,110	1,321,110	1,250,000	1,250,000
Foreign Official Institutions	320,000	320,000	559,300	559,300
TOTALS	$17,616,290	$6,563,600	$17,326,325	$6,557,025

1/ Equivalent coupon-issue yield.

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FOR RELEASE AT 8:30 p.m., E.S.T.
April 1, 1985

REMARKS BY
SECRETARY OF THE TREASURY
JAMES A. BAKER, III
AT THE
ECONOMIC CLUB OF NEW YORK
APRIL 1, 1985

Thank you very much.

This is my second attempt to speak to the Economic Club of New York. I was invited back in 1982, but budget matters forced me to cancel at the last minute. So I thank you for this raincheck. It's a pleasure to be here this evening, and an honor to address such a distinguished group.

In case you haven't noticed, today is April Fools Day -- when everything's a joke. This contrasts with April 15th -- when nobody's laughing. And, like any well-prepared speaker, that reminds me of a story.

An income tax collector died and arrived at the pearly gates. Just ahead of him were two clergymen, but St. Peter motioned them aside and took the tax collector right in. "Why him ahead of us?" the surprised clergymen asked. "Haven't we done everything possible to spread the good word?"

"Yes," said St. Peter, "but that guy scared the hell out of more people than you ever did."

A lot has happened in the time between that first invitation to speak here and today. Back in 1982, the country was in recession. But, with honest optimism, I still would have told you that the future looked bright.

Today is that future. We're in the 29th month of recovery and growth. Our economy has been shining -- with real growth last year the highest since 1951.

Hundreds of thousands of jobs are being created every month -- over 7-1/2 million during this expansion. Capital spending has outpaced gains during any previous postwar recovery.

And inflation has been held at bay -- dramatically below the double-digit levels that were crushing our spirit and ruining our economy only a few years ago.

The reason for all this success, and the reason that even in 1982 I could have spoken here with optimism, has been the unyielding belief of this Administration in sound, commonsense economic policy and the unwillingness to buckle under pressure for traditional, quick-fix "solutions."

We held on doggedly to our faith in the power of free markets, incentive-spurring tax cuts, and the creativity of the individual. We pushed hard to control federal spending, cut needless or out-of-date regulation, and restore economic power to the people.

The result? America's economy has been catapulted out of the stagflation and morass of the 1970s. And more important, we have restored confidence in market-oriented economic policies; we have renewed our faith in America's power to produce jobs and well-being through growth; and in so doing, we have begun to lay a firm foundation for sustained economic development without inflation.

We have returned to a position of strength in the world economy, as well. And this American economic might is helping to pull other nations up off the mat. Most haven't recovered to the extent we have and this, along with the international debt problem, has kept the relative attractiveness of U.S. investment strong, and thus kept the dollar strong -- stronger than some would like.

But even those who find fault with the dollar's strength are realizing that the United States cannot go back to the traditional, quick-fix mentality.

Rather than artificially lowering the dollar, others are coming to see that sound, convergent, market-oriented economic policies are the best means to assure long-term stability.

With the international debt problem, we've seen a similar acceptance of work, dedication and patience as the proper means to overcome a serious threat to the worldwide financial system.

At the 1983 Williamsburg Summit, we adopted a five-point strategy for managing the debt problem. Its basic elements were, and are: economic adjustment by debtor countries; growth and open markets in the industrialized nations; adequate resources for the IMF; continued bank lending to those countries who are making determined adjustment efforts; and emergency bridge loans by governments to aid adjustment programs. That strategy is working.

The process is not always easy. In fact, it is often difficult for all concerned. But it is effective.

We're encouraged by the progress of Mexico, the nation that led off a wave of debt problems in Latin America and elsewhere two and a half years ago. Mexico has battled back and is now held up as a model for other debtor nations to follow.

The battle is far from over, but in Mexico and throughout the international community, if we stick by our basic strategy, if the debtor countries, the IMF, the lenders and industrial nations continue to work together, then the debt problem will continue to be manageable in the short-term and even solvable in the long-run.

In the meantime, we've got more to do right here at home. It would be a serious mistake to let this recovery breed complacency. Our domestic economy is growing and thriving as a direct result of economic policies implemented in 1981. We must build on what we've started; extend those policies and philosophies that have brought us this far, for they promise to carry us much farther.

I want to interject here that I am not troubled by the first quarter flash for growth and inflation. The early data suggest that GNP is rising at only a little over 2 percent, while the GNP deflator is projected at above 5 percent. However, most private economists believe that this flash estimate reflects a number of aberrant technical influences and that real growth has been understated, while inflation has been overstated. In addition, February's leading indicators suggest that we'll continue to see moderate growth.

And I believe we will see growth continue for a long while yet -- if we continue what we started four years ago, and if the Congress acts responsibly to implement the President's program. Our efforts right now center on the control of federal spending and on tax reform. These are the top two domestic economic issues we face.

On spending control, we are encouraged by the way the terms of the debate have been framed. No longer is the question "should we cut spending?", it is now "how should we cut spending?"

On tax reform, we are undertaking an historic challenge. And because, at the President's direction, I am leading the Administration's efforts to refine our proposal, I will devote the balance of my remarks tonight to that topic.

I remember my first briefing on the subject as Treasury Secretary. One of my advisors told me: "Mr. Secretary, I know you think coming up with passable tax reform legislation is going to be very tough. But if you look at it this way, it doesn't seem all so monumental. There's only two types of people complaining about the tax system," he said. "Men and women."

Well, that about sums it up, I think. A lot of people are complaining. In fact, recent studies find that:

-- 4 out of 5 taxpayers believe the present tax system benefits the rich and is unfair to the ordinary working man or woman;

-- a majority of taxpayers believe the federal income tax system is too complicated; and

-- a majority of respondents perceive that cheating on income tax is rampant.

I think it's clear that, where our tax system is concerned, there is a widespread populist sentiment in favor of major reform. And more importantly, this sentiment is rooted in legitimate concerns.

Now, of course, there is substantial resistance to some of the particular changes that would be brought by a comprehensive tax overhaul. But we firmly believe that the majority of Americans would forego some aspects of the system which benefit them individually, for a simpler and fairer system with lower tax rates.

More than 70 years of piece-meal changes in the tax code has culminated in a system that has fundamental shortcomings.

It is riddled with inequities. It has grown unacceptably complex. It requires high tax rates to provide sufficient revenue. And it is adversely affecting what should be economic decisions by businesses, investors, and yes, even average individual taxpayers.

And perhaps most importantly, the present situation has led to a loss of respect for the tax system, which translates into a loss of respect for government generally. To the extent that we can improve our tax system, we will be improving government and the public's perception of government. To the extent that we fail to do so, we will be allowing a regrettable and corrosive tendency toward alienation and cynicism to persist.

I know that problems with the tax code aren't news to you. For years we've heard the complaints. And Washington has often taken a stab at tax reform. But it's only recently, since President Reagan directed a full study in his State of the Union Address a little over a year ago, that real, comprehensive reform has become a possibility.

He reconfirmed his concern in the most recent State of the Union two months ago. He spoke of a "Second American Revolution" -- a revolution of hope and opportunity for all Americans. Tax reform is most definitely one of the means to lead us to, and assure the continuance of, a successful revolution.

It's not an easy task. We don't underestimate the difficulty involved, nor minimize the importance of our actions. In fact, tax reform is among the most ambitious undertakings of this Administration. But the time for such bold action hasn't been better in many years. We've got a thriving, strong economy, and believe me, that makes our efforts a lot less difficult.

We've also got something of a consensus among the leading proponents of tax reform. All of them agree that our present system is flawed and that some kind of comprehensive reform is needed. And among the major reform proposals, the same basic philosophies are shared, even if all the same specifics are not.

We've been meeting almost daily with members of Congress, representatives of the business community, and other affected parties. And we're entering these discussions with open minds, a willingness to listen and a willingness to examine all aspects of reform.

There's not too much, for our part, that's already etched in stone. But there are several important, general guidelines that we think should shape the dialogue.

First of all, we believe that tax rates are still too high and must be reduced. High tax rates stifle incentives to work, save, and invest. They discourage invention, innovation, and risk taking. They encourage wasteful tax shelter investment and they stimulate underground economic activities.

It is far better to levy a low rate of tax on all income than to tax only some income at extremely high rates. By bringing untaxed income into the tax base we can reduce high marginal tax rates for both individuals and corporations without any loss of revenues in the short run.

In the longer run, those lower rates should lead to even higher revenues through sustained growth of the tax base.

Secondly, any tax reform proposal must be revenue neutral. The Administration is adamantly opposed to reform being a tax increase in disguise.

Now this means grappling with two forces that we know are lurking in the shadows -- those who will attempt to combine tax reform with deficit reduction; and those who will lobby hard to have their special tax treatment retained in any new law.

We can't give in to either pressure. Tax reform and deficit reduction each has its own singular importance. Both are economic priorities. But they must remain separate issues.

Similarly, the special interests must understand that we can't exempt every preferential treatment, deduction and credit that has a constituency and at the same time bring down tax rates.

Now, having just said that, I am going to mention one item that we do want exempted. That is the deduction for home mortgage interest. It is part of the President's concern, as well as ours, that families be treated fairly and assigned the importance they deserve as the foundation of American society.

Widespread home ownership provides a sense of well-being and social stability that we believe strengthens the family and, through that, all of society. The deduction for mortgage interest makes homeownership easier and more likely and warrants special consideration.

Even more important under our fairness to families guideline is that people living in or near poverty pay no income tax. I don't think too many would argue that those applying everything towards bare necessities of life should not have the added burden of income tax.

A fourth criterion is formally called "economic neutrality." Simply put, this means all sources and uses of income should be taxed equally. And this requires, again, that most special exclusions, adjustments, credits and deferrals that favor certain sources and uses of income be eliminated.

We believe that a free market is the best method for allocating resources in the most efficient manner. It provides the best data and best signals for investors, consumers, savers and businesses.

But right now, our economy in some respects can be severely distorted because what should be economic decisions are decisions driven instead by tax considerations. While a pure, economically neutral system may be unattainable, we should make every effort to devise a system as unbiased and economically efficient as possible.

I know this aspect of tax reform is of great importance to many in this audience. There's been a concern on the part of many in the business and industrial sectors that some reform proposals may damage capital formation. Let me assure you that we will be looking carefully at these elements of any plan. We don't want to kill the goose that lays the golden egg.

Our overall economic objective is and has been stronger economic growth. There is no contradiction between tax simplification and economic growth. They can and should go hand in hand.

We're well aware of the integral part capital formation has in providing and sustaining growth in an economy. And we're well aware that economic risk and investment are functions of potential gain. We obviously need to find a balance. We need the entrepreneurs, innovators and risk-takers.

The complexity of our tax code seems to be the federal government's unintended method of adding insult to injury. And because of ever-changing statutory provisions, I don't see the system growing any simpler on its own. Simplifying the tax code must be among our objectives.

Within this framework lies a good foundation for tax reform. We won't abandon the guidelines I've gone through today, but we are receptive to sound suggestions and alternatives that may benefit taxpayers and the economy.

One alternative we don't have is inaction. What our tax system has developed into is contrary to so much of what has powered our nation for two centuries that we must achieve comprehensive reform.

To let the present system of piece-meal change and debilitating complexity continue would be to risk a lot. Eventually, a flawed tax system would catch up with us. And the price would be less growth, less opportunity and less hope.

Perhaps you've heard it said that destiny is not a matter of chance, it is a matter of choice. It is not a thing to be waited for, it is a thing to be achieved.

Well, the way I see it, we can take a chance and wait. Or we can make a choice and achieve. It's clearly up to us. I think our decision should be evident.

Thank you.

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STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairmen and Members of the Subcommittees:

I am pleased to appear before you today to discuss some of the more significant Federal income tax aspects of corporate acquisitions. The recent surge in merger activity and the publicity surrounding recent acquisitions (and attempted takeovers) of large, publicly held corporations has renewed concern that our tax laws inappropriately encourage these transactions. We do not know all of the economic and other reasons behind the recent flurry of activity. However, we doubt that tax considerations are the driving force. We suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale, increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions; I will not today speculate on their decision making process, instead I will concentrate on the principal tax aspects of mergers and acquisitions and defer to the expertise of others on the effect of these corporate acquisitions on the economy as a whole.

While it is doubtful that our tax laws are primarily responsible for the recent merger upswing, they play an important role in these transactions, just as they do in virtually every business transaction corporations conduct. The subject of the hearing today concerns those aspects of our current tax laws that exert the greatest influence on merger activity. The first part of my testimony summarizes the different types of corporate acquisitions and describes the divergent tax consequences that may be obtained. The second part of my testimony discusses certain structural features of our tax system that appear to encourage corporate acquisitions and takeovers. The third part of my testimony describes recent trends in merger activity that raise significant tax policy issues. Included among these are the use of ESOPs in leveraged buyouts, the use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions and the carryover of tax attributes in mergers and acquisitions of thrift institutions. Finally, I will discuss certain legislative proposals that are inspired by the current wave of mergers and acquisitions.

I. Taxing Corporate Acquisitions - An Overview

In general, for tax purposes, corporate acquisitions are categorized into two basic forms -- taxable and tax-free. While this categorization vastly oversimplifies how the tax law applies to these transactions, it is useful in analyzing the important tax policy questions in this area to think of the transactions as coming within one of these two categories; for it is this categorization that will trigger the most significant tax consequences. This first part of my testimony summarizes the types of mergers and acquisitions that come within each category and their principal tax consequences.

A. Tax-Free Acquisitions

The distinctive characteristic of a wholly tax-free acquisition is that no gain or loss is recognized by the target corporation or its shareholders. The target shareholders are permitted to roll over their investment position in the target corporation for an investment position in the acquiring corporation without paying current tax. This tax-free rollover, however, is generally available only to the extent the target shareholders receive stock of the acquiring corporation or certain related corporations. Other consideration received by the target shareholders is taxable either as dividend income or capital gain, depending upon the application of a complicated set of judicial and statutory rules that strive to make this ever difficult distinction.

A tax-free acquisition generally will not generate taxable income to the target corporation, even if that corporation has appreciated assets. The corollary of this tax-free treatment is that the target corporation's historic tax basis for its assets "carry over" to the acquiring corporation and are not "stepped-up" (or down) to fair market value. Moreover, with certain limitations discussed below, tax attributes of the target corporation, such as net operating losses and unused credits and accumulated earnings and profits, will also carry over to the acquiring corporation.

To qualify as a tax-free acquisition, the transaction generally must qualify as a "reorganization" as defined in section 368 of the Code.*/ Although the statutory definition and judicial interpretations place significant constraints on how a reorganization can be structured, significant flexibility does exist. Thus, a tax-free acquisition can take the form of a direct acquisition of the target corporation's assets, the acquisition of the target corporation's stock, or a combination of the target and the acquiring corporation pursuant to statutory merger or consolidation.

B. Taxable Acquisitions

The principal characteristic of a taxable acquisition that sets it apart from a tax-free acquisition is that the seller in a taxable acquisition cannot receive a tax-free rollover of his investment. The seller in a taxable acquisition can be either the target corporation (a taxable asset acquisition) or the target shareholders (a taxable stock acquisition). The collateral consequences of a taxable asset acquisition and a taxable stock acquisition differ in so many respects that each will be discussed separately.

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*/ A "reorganization" is defined in section 368(a) as including four basic types of acquisitions: statutory mergers (type "A" reorganizations), stock-for-stock exchanges (type "B" reorganizations), asset-for-stock exchanges (type "C" reorganizations), and bankruptcy reorganizations (type "G" reorganizations). Tax-free acquisitions can also be effected through compliance with section 351. In addition to satisfying the statutory definition, a reorganization must meet certain other regulatory and common law tests (such as the "continuity of interest" and "continuity of business enterprise" tests) in order to qualify as a reorganization. Although there is some uncertainty regarding application of these statutory and judicial tests to particular fact patterns, there is a substantial body of case law and Internal Revenue Service rulings and past history that provide guidance to taxpayers.

1. Taxable Asset Acquisitions

In a taxable asset acquisition, gain or loss is recognized by the target corporation, unless, as discussed below, the target corporation is completely liquidated within a statutorily prescribed time. The sale may be reported on the installment method, however, in which case any capital gain is deferred and reported as the installment payments are received. In any case, the tax basis of the assets acquired are adjusted to reflect the purchase price paid for those assets. In a taxable asset acquisition, the acquiring corporation does not succeed to any of the target corporation's tax attributes, such as net operating losses and unused credits and accumulated earnings and profits. These tax attributes, however, will be available to offset the target corporation's income and tax liability resulting from the sale.

If a transaction is a taxable asset acquisition from a corporation that has adopted a plan for complete liquidation within a 12-month period, generally no gain or loss is recognized by the selling corporation (except to the extent of recapture and other tax benefit items). Gain or loss is recognized, however, by the shareholders of the liquidating corporation based upon the difference between the amount of the liquidation proceeds received and their stock basis. If the target corporation sells its assets for installment notes that are distributed in liquidation, the target shareholders can report their gain on the installment basis to the extent they receive the notes.

2. Taxable Stock Acquisitions

In General. If a transaction is a taxable stock acquisition, gain or loss generally will be recognized by the selling shareholders, but may be reported on the installment method if installment notes are received. The tax consequences to the target corporation and the acquiring corporation depend upon whether the acquiring corporation makes a section 338 election.

The immediate effect of a taxable stock acquisition is that the target corporation becomes a subsidiary of the purchasing corporation. If no section 338 election is made for the target corporation, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations discussed below. If a section 338 election is made, the taxable stock acquisition takes on most of the characteristics of a taxable asset acquisition from a liquidating target corporation.

Section 338 Elections. A section 338 election is available where one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. In such case,

the purchasing corporation may elect to adjust the basis of the assets of the target corporation as though the target corporation sold all of its assets to a new corporation in connection with a plan for complete liquidation within a 12-month period. The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/ A section 338 election requires that the target corporation generally recognize its recapture and other tax benefit items as if it had sold its assets pursuant to a plan of complete liquidation.

Section 338 also contains consistency rules designed to prevent a purchasing corporation from obtaining a step-up in basis for some of the target's assets, while preserving target's corporate tax attributes and historic tax basis for other assets. The typical case addressed by these rules is one where target has one group of high value, low basis assets with respect to which the purchaser wants to take depreciation, amortization, and depletion deductions on a stepped-up basis, and another group of assets which may carry either a significant recapture or other tax liability or valuable tax attributes (such as net operating loss or credit carryforwards). If the purchasing corporation were to acquire all of target's assets, all assets would receive a stepped-up basis, target (assuming target liquidated within a 12-month period) would be taxed only on the recapture and tax benefit items on all assets, and the corporate tax attributes of target would be extinguished. From a tax planning perspective, the purchasing corporation would like to step-up the basis of the first group of assets (for instance, by a direct asset purchase), yet avoid the recapture tax and maintain a carryover of basis for

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

the second group of assets and the valuable corporate tax attributes of target (by acquiring all of the target stock and not making a section 338 election).

To prevent this type of tax motivated tailoring acquisitions, the consistency rules require that the purchasing corporation must elect either to step-up the basis of all acquired assets (with the associated recapture and loss of corporate tax attributes) or to carry over the basis of all acquired assets (generally with the continuation of tax attributes). Section 338 generally provides that a step-up in basis (and attendant recapture and other tax consequences) will be triggered automatically if, within the period beginning one year before the beginning of the acquisition and ending one year after control is acquired, any member of the purchasing group acquires the stock of any corporation affiliated with the target corporation (target group) or an asset from any member of the target group, other than in certain defined transactions.*/

C. Carry Over of Corporate Tax Attributes

1. In General

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to carry back the loss to offset income earned in the three taxable years preceding the year in which the loss is incurred and to carry forward any excess to offset income earned in the 15 years after the loss is incurred. A net capital loss generally may be carried back to the three taxable years preceding the loss and then carried forward to the five taxable years succeeding the loss. The underlying premise of allowing a corporation to deduct a net operating loss or a net capital loss incurred in one year against taxable income earned in another year is to ameliorate the unduly harsh consequences of an annual accounting system. In other

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*/ The excepted transactions included transactions in the ordinary course of business, carryover basis transactions, pre-effective date transactions, and other transactions to the extent provided in regulations. In some cases, the consistency rules can operate to require taxpayers to take a step-up in basis and pay recapture taxes or suffer other tax detriments where no manipulative scheme exists. As contemplated by Congress in the Tax Reform Act of 1984, Treasury is considering allowing taxpayers to elect carryover basis (or cost basis when less than carryover basis in a particular asset) in all assets that a corporation acquires during the consistency period. We do not believe that the providing of this "carryover basis election" would create any significant new tax incentives for corporate acquisitions provided there are appropriate safeguards.

words, the ability to carry losses back and forward is intended as an averaging device. For similar reasons, corporations that are unable to use all their credits against tax in the year in which the credits are earned may use such excess credits to offset tax liability in the three prior taxable years and the 15 succeeding taxable years.

The ability to carry over net operating losses, unused credits, and other tax attributes following certain corporate acquisitions, as described briefly above, may affect such acquisitions in a variety of ways. The ability to carry over corporate tax attributes, for example, may affect both the form of acquisitive transactions and the price paid or the value of other consideration used in such transactions. Moreover, the ability to carry over tax attributes may in certain instances influence whether an acquisition will be undertaken. The ability to carry over tax attributes after a corporate acquisition, however, is limited under current law in several respects.

As mentioned above, the tax attributes of a target corporation generally survive a tax-free reorganization and carry over to the acquiring corporation. In addition, if a corporation acquires the stock of another corporation in a taxable transaction, the tax attributes of the target corporation also survive the acquisition, unless a section 338 election is made for the target corporation. Moreover, although a purchasing corporation that does not make a section 338 election will not succeed directly to the tax attributes of the target corporation, it may benefit from the target corporation's net operating losses, net capital losses, unused credits, and other tax attributes, if the target and purchasing corporations join to file a consolidated income tax return. Alternatively, a purchasing corporation that does not make a section 338 election may inherit the tax attributes of the target corporation if the target is liquidated or merged into the purchasing corporation.

2. Limitations on the Carry Over of Tax Attributes

Under sections 382 and 383, */ the ability of an acquiring or purchasing corporation to use or benefit from the net operating

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*/ Sections 382 and 383 were substantially amended in the Tax Reform Act of 1976, but the effective date of those amendments has been delayed several times. Most recently, section 61 of the Tax Reform Act of 1984 extended the effective date of the 1976 Act amendments until December 31, 1985. The 1976 Act rules, as well as current law, have been criticized and a number of reform proposals have been made. Although we understand that the Subcommittees are not examining sections 382 and 383 in detail at this hearing, we believe that it is important that Congress address these provisions this year and we look forward to working with the Congress in developing reasonable rules governing the carry over of corporate tax attributes.

losses and other tax attributes of a target corporation following a taxable stock acquisition or a tax-free reorganization may be limited. Sections 382 and 383 were enacted to establish objective tests that would curb "trafficking" in corporations with unused net operating losses and other favorable tax attributes. In the case of net operating loss carryovers, Congress was particularly concerned that profitable, operating corporations were acquiring shell corporations whose principal assets were unused net operating losses that could be applied against income of the acquiring corporations that was unrelated to the business activity of the acquired corporations.

In addition to the specific objective limitations provided by sections 382 and 383, the carry over of net operating losses and other favorable tax attributes may be disallowed under section 269, whenever the principal purpose of an acquisition of stock or assets is to obtain the benefit of losses, deductions, or credits. Thus, section 269 may be applied to deter misuse of the general carryover limitation provisions.

Finally, the ability of an acquiring corporation to benefit from the tax attributes of a target corporation by joining with the target to file a consolidated income tax return is limited by the "separate return limitation year" and "consolidated return change of ownership" rules provided in applicable Treasury regulations. In addition to limiting use of net operating loss and credit carryovers, the consolidated return regulations under certain circumstances also limit the ability to benefit from "built-in" losses following an acquisition.

II. Structural Aspects of the Income Tax That May Encourage Corporate Acquisitions and Takeovers

While we believe economic as opposed to tax considerations typically drive a corporation's decision to acquire another corporation, we recognize that there are a number of structural features of our current income tax system that may encourage corporate acquisitions. The Committees may wish to consider removing or modifying some of the current law provisions that encourage merger activity. As the discussion below will indicate, however, some of the incentives in current law are rooted in the basic structure of how we tax corporations and their shareholders and could not be altered without fundamentally changing the present income tax system.

A. Double Taxation of Corporate Earnings

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income, and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends

are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating assets as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. The double taxation of dividends and the tax-free basis step-up at death operate in tandem to place extreme pressure on closely-held corporations to retain rather than distribute earnings.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt to equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate. The incentive for leveraged buyouts conferred by the more favorable tax treatment of interest payments is discussed further in part III.A.1., below.

B. Capital Gain - Ordinary Income Distinction

Currently, corporations are subject to tax on ordinary income at a maximum rate of 46 percent and on capital gains at a maximum rate of 28 percent. Individuals are subject to tax on ordinary income at a maximum rate of 50 percent and on capital gains at a maximum rate of 20 percent. While corporate taxable income distributed to individual shareholders as dividends generally bears two ordinary income taxes, the shareholder's receipt of cash or property in exchange for his stock in a purchase of the corporation results in a significant lessening of the double tax burden when compared with the receipt of such cash or property as dividend income. Even though corporate earnings distributed as dividends would be taxed to the shareholders at ordinary income tax rates, the gain attributable to retained earnings is taxed at preferential capital gains rates if the shareholders sell their stock. This capital gain opportunity results in an incentive for the corporations to retain income in corporate solution and for corporate acquisitions.

C. Underutilization of Capital Subsidies

Capital subsidies (such as certain credits and accelerated depreciation) provided through the tax system may have an unintended ancillary effect of encouraging mergers and acquisitions. In some cases the amount of these tax subsidies have outstripped the recipient corporation's ability to use them effectively by investing in operating assets. To the extent that a corporation cannot effectively reinvest the tax subsidies in operating assets, such amounts are invested in nonoperating assets, which stimulate merger activity as detailed in part II.A., above.

In addition, whenever a company does not have enough income and tax liability to benefit from the accelerated depreciation and tax credit capital subsidies, an incentive for mergers is created. As summarized earlier, there are limitations on the use of tax attributes of an acquired corporation, but these limitations do not apply to certain forms of mergers or acquisitions. And even in cases in which the limitations apply, the acquiring corporation may nevertheless benefit to some extent from the target corporation's tax attributes.

For example, the limitations provided in sections 382 and 383 generally would not apply if a corporation with substantial unused net operating losses and excess credits acquired a profitable target corporation's stock or assets in either a tax-free or taxable acquisition. Accordingly, income and tax liability generated by the target corporation or its assets could be offset in future years by the acquiring corporation's unused tax attributes. Similarly, if an acquiring corporation purchased the stock of a target corporation in a taxable acquisition and did not make a section 338 election, the acquiring corporation could use the target corporation's net operating losses to offset future income of the target corporation. If, on the other hand, the acquiring corporation made a section 338 election, although it would not succeed to the target corporation's tax attributes, any income realized by the target corporation by virtue of the section 338 election and the accompanying tax liability could be offset by the target corporation's net operating loss and credit carryforwards.

The ability to benefit from net operating loss and other carryforwards following the acquisition of a corporation is not necessarily inconsistent with sound tax policy. As discussed earlier, a corporation is allowed to carry back and carry forward its unused net operating losses and credits without limitation (other than on the number of carryback and carryforward years). These unused net operating losses and credits may result from capital subsidies to which the corporation is entitled, but is unable to utilize currently. The carry over of net operating losses and other tax attributes following a corporate acquisition may properly allow the target corporation to effectively benefit from the capital subsidies in the same manner as if no acquisition had occurred. Nevertheless, the tax rules governing the carry over of tax attributes should not encourage corporate acquisitions that would not be undertaken on purely economic grounds. Moreover, those rules should not result in tax attributes becoming more valuable in the hands of an acquiring corporation than they would have been in the hands of a target corporation.

In general, we believe that the existing limitations on the carry over of corporate tax attributes do not work well in some respects and improperly allow the carry over of tax attributes in some cases. We do not believe, however, that either the ability to carry over tax attributes in a corporate acquisition or the imperfections in the existing statutory and regulatory limitations on such carryovers is the fuel driving the recent surge of corporate acquisitions. Nevertheless, we do look forward to working with the Congress in reforming those rules this year.

We want to point out, however, that the existence of unused tax attributes and the ability to benefit from such attributes by acquiring control of a corporation would be of much less concern

if corporate taxable income were measured correctly and, for example, the existence of unused net operating losses meant that a corporation had realized actual economic losses. Under current law, however, a corporation that earns a significant profit may nevertheless have substantial net operating losses and other unused tax attributes. Current law does not provide for direct reimbursement of net operating losses or refundability of credits by the Federal government and does not permit corporations with unused tax attributes to transfer those attributes freely to other corporations that can benefit from them. The consequence of such a system is the existence of an increased volume of tax attributes that can not be used by the corporations to which they are made available. The lack of refundability or free transferability and the resulting increase in the volume of unused tax attributes place significant pressure on the rules that are designed to limit the use of net operating losses and excess tax credits following an acquisition and provide an incentive to acquire corporations with such unused tax attributes.

Moreover, the mismeasurement of income for tax purposes and the resulting increased volume of unused tax attributes may favor conglomeration by encouraging corporations that are engaged in business activities that generate "tax losses" and excess tax credits to combine with other corporations that are engaged in activities with fewer tax attributes. The tax laws should not create such a bias between diversified and non-diversified entities.

The adoption of a system that correctly measures economic income would eliminate the possibility that profitable corporations could have unused net operating losses or excess tax credits and would ensure that companies with loss carryforwards had suffered equivalent economic losses. The importance of rules limiting the use of tax attributes following corporate acquisition would thus be decreased. The proper measurement of corporate income also would greatly diminish the volume of unused favorable tax attributes, and correspondingly reduce the importance of tax attributes in decisions regarding corporate acquisitions and conglomeration.

D. General Utilities Doctrine

Some have argued that the section 338 rules and the liquidation rules conflict with the general scheme for taxing a corporation and its shareholders and may encourage corporate acquisitions. Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock with a section 338 election, there is a step-up in basis of assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the

rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336, and 337. Under those provisions, a corporation recognizes no gain (other than recapture and tax benefit items) on distributions, including liquidating distributions, made to its shareholders. These rules may give an additional incentive to a corporation to sell assets in some cases because it increases the likelihood that the present value of the tax benefits that accompany property ownership (e.g., depreciation and depletion deductions) may exceed the seller's tax detriment incurred on the sale. Thus, the same assets may be more valuable to a buyer than to the current owner.

Congress has reduced this incentive to sell corporate properties by limiting the scope of the General Utilities rule. For example, TEFRA made distributions of appreciated property in a partial liquidation taxable to the distributing corporation. In addition, the Tax Reform Act of 1984 (the "1984 Act") imposed the same treatment on dividend distributions of appreciated property. One major aspect of the General Utilities doctrine remains, however. Nonrecognition of gain by the selling corporation continues to be the general rule in connection with a complete liquidation and a deemed asset sale in connection with a section 338 election (although recapture and tax benefit items are taxed). While repeal of this last major exception would simplify the tax laws, we do not believe that the failure of the corporate tax regime to impose two levels of tax on liquidation transactions is primarily motivating corporate acquisitions. Further, as we have indicated in prior testimony before the Senate Finance Committee, we believe that in considering the repeal of General Utilities in liquidation transactions, relief from double taxation of liquidation proceeds must also be considered.

E. Inadequate Recapture Taxes

1. In General

Some have suggested that the imperfections in the current recapture rules may be a factor encouraging corporate mergers and acquisitions. If the General Utilities rule were fully repealed and a corporation were required to recognize gain to the extent the amount realized exceeds its basis in assets, the effectiveness of the recapture rules would not be as important. Short of a complete repeal of the General Utilities rule in a liquidation context, it may be appropriate to tighten current recapture rules. For example, under current law, a liquidating corporation that used the last-in first-out ("LIFO") method of accounting for inventories is required to recognize income attributable to the difference between the value of inventory determined on the LIFO basis and that determined on a first-in first-out ("FIFO") basis (commonly called LIFO reserve). This rule could be expanded to include all inventory profit (not just

the difference between LIFO and FIFO) and all other ordinary income. In addition, the recapture rules on section 1250 property (including residential real estate) could be conformed to the section 1245 recapture rules applicable to personal property to require the liquidating corporation to recapture ordinary income to the extent of the full amount of prior depreciation allowed. These changes would be premised on the notion that the corporation claiming tax benefits should return those benefits at the time of sale (whether by actual sale or in liquidation) if the sale shows that the earlier granted benefits were excessive.*/ Any strengthening of the recapture rules, however, magnifies the potential double taxation of corporate earnings and any change in the recapture rules should be coordinated with proposals to relieve that double tax burden.

2. Mineral Property

Under current law, gain on the disposition of mineral property is recaptured as ordinary income under section 1254 to the extent of intangible drilling costs that were deducted after December 31, 1975. There is no recapture, however, with respect to gains from the sale of mineral property for which intangible drilling costs were deducted prior to that date. Consequently, on the sale or exchange of mineral properties, gain attributable to expenses deductible against ordinary income as intangible drilling costs prior to 1976 is taxable at capital gain rates even though the drilling expenses were deducted against ordinary income.

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*/ It should be noted that recapture and tax benefit items generally are not recognized upon the sale of a subsidiary. However, such a result may be inconsistent with the basic principles of the recapture rules where the selling corporation and its subsidiary joined in filing a consolidated return for all years in which the deductions (or credits) were claimed. The consolidated return regulations provide for an annual basis increase (or decrease) in the parent's stock in the subsidiary based on the annual increase (or decrease) in earnings and profits, rather than taxable income, of the subsidiary for such year. Some have suggested that these rules may permit the selling parent corporation to understate its gain (as well as avoid recapture income) because the basis of the subsidiary's stock is inappropriately increased whenever the earnings and profits increase in an amount greater than taxable income. This disparity between earnings and profits and taxable income typically is due to certain tax subsidies, such as accelerated depreciation. The Internal Revenue Service takes the position that allowing this basis increase would result in impermissible double deductions to the selling affiliated group and is currently litigating this issue.

Prior to 1975 integrated oil companies could deduct percentage depletion at a rate of 22 percent with respect to mineral property. Percentage depletion deductions are not limited to the taxpayer's basis in the mineral property; so that, with respect to pre-1975 properties, the adjusted depletable basis (investment costs other than intangible drilling costs) for most taxpayers is zero. Since 1975, however, integrated oil companies have been required to use cost depletion. Thus, in effect, most integrated oil companies receive no depletion allowances if they continue to produce from pre-1975 properties. Upon a disposition of mineral property to another who would be allowed cost depletion for the same property, current law does not require recapture of either cost or percentage depletion allowances; this rule applies whether or not percentage depletion allowances were taken in excess of the taxpayer's basis.

Some have suggested that recapture rules should be applied to intangible drilling costs deducted in respect of mineral properties regardless of when the deductions were taken. We cannot support such a change. The recapture of intangible drilling costs was considered extensively by Congress in connection with legislation in 1976. Congress enacted a recapture provision at that time and settled upon what it considered to be a fair transition rule. We do not believe that it is appropriate to change that transition rule retroactively.

Suggestions also have been put forth to apply recapture rules to percentage and cost depletion allowances. Normally, as in the case of depreciable personal property, recapture of depreciation is provided when the property is sold or exchanged; only the excess of the selling price over original basis is eligible for capital gains rates (and nonrecognition at the corporate level in a liquidating sale). The lack of adequate recapture rules creates an incentive to sell to a buyer who will obtain the benefit of a step-up in basis (and therefore larger deductions against ordinary income) at the cost of only a capital gains tax to the seller. The failure to recapture cost depletion allowances thus may provide some incentive for acquisitions of companies with mineral properties. We do not believe the recapture rules applicable to mineral property should differ from the current recapture rules applicable to personal property. In either case, full recapture is needed to minimize inefficient churning of such property solely for tax reasons.

Although we would support full recapture of cost depletion, we would not support the application of recapture rules to percentage depletion. The percentage depletion allowance is, in effect, a negative excise tax on the production of minerals which results in a lower effective income tax rate for those eligible for its benefits. While it may be appropriate to consider reducing or eliminating future allowances for percentage depletion, we do not believe the special rate of tax on mineral properties that Congress provided by way of the percentage

depletion allowance should be retroactively repealed by extending the recapture rules. Congress dealt with the policy considerations involving the availability of this special tax incentive to integrated oil companies by limiting such taxpayers to cost depletion for taxable years ending after December 31, 1974.

III. Recent Developments in Corporate Acquisitions that Raise Significant Tax Policy Issues

The structural aspects of the current income tax law discussed above may encourage merger and acquisition activity to some degree, but as stated at the outset, we do not believe they are the driving force behind the current flurry of activity. A number of the publicized acquisitions that are of interest to the Committees involve tax techniques that have only recently evolved, and to some extent these techniques are based upon recently enacted tax incentives. We are concerned that these tax incentives are being employed in mergers and acquisitions in ways that Congress did not intend. Principal among our concerns are the use of ESOPs in leveraged buyouts and the carryover of tax attributes in mergers and acquisitions of thrift institutions. I would also like to comment upon the growing use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions.

A. Leveraged Buyouts and the Growing Use of ESOPs

1. Leveraged Buyouts

The prototypical leveraged buyout involves the conversion of a publicly held company into a private company pursuant to an acquisition by a newly organized private company of all of the target company's stock. The acquiring company usually is organized and controlled by the senior management of the target company. The private company's acquisition of the target stock is largely debt financed, with the expectation that the debt will be retired out of future earnings of the company.

As is the case with other mergers and acquisitions, we expect that leveraged buyouts are motivated primarily by economic factors. Nevertheless, the income tax law to some extent may encourage leveraged buyouts of corporations by the more favorable tax treatment of interest payments. As discussed earlier in part II.A., the deductibility of interest payments by a corporation compared to the nondeductibility of dividends encourages corporations to use debt rather than equity in financing operations or acquisitions because of the potential for double taxation of corporate earnings distributed as dividends.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages these acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expenses but no realization of the increase in value of the asset until its sale or disposition. In such cases the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern these Committees, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

The tax arbitrage from debt financing generally is available for all debt-financed assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with corporate acquisitions.

2. Leveraged Employee Stock Ownership Plans

While every leveraged buyout raises the concerns just noted, we have particular concerns about the use of leveraged employee stock ownership plans (ESOPs) to effectuate leveraged buyouts and to defend against attempted takeovers. Since Congress first

established special tax incentives for ESOPs, these plans have been used frequently in leveraged buyouts, but the 1984 Act makes ESOPs an even more attractive vehicle for purchasing shares in a leveraged buyout.

In a leveraged ESOP, the ESOP borrows to purchase stock of the company that establishes the ESOP, and the company obligates itself to contribute amounts to the ESOP sufficient to enable it to service the debt. The employer may deduct these contributions to the ESOP currently without regard to the restrictive limits on employer contributions to other types of employee benefit plans. Because the ESOP is a qualified plan, an employee participating in the ESOP is not required to include these contributions in income until he or she receives a distribution from the plan.

Under the terms of a typical leveraged ESOP, employees are not entitled to distributions from the plan until separation from service. When the ESOP distributes stock to a participant, the employee is taxed on the value of the stock (determined with reference to the price paid by the ESOP) and accumulated income which has been allocated to the participant's account. A participant has the right to require the employer to purchase the stock from the participant at fair market value, unless the stock is readily marketable and traded on an established securities market.

An ESOP is required to give covered employees the right to vote publicly traded shares held by the ESOP. But employees can vote shares held by the ESOP that are not publicly traded, only with respect to actions (such as mergers or liquidations) which require an affirmative vote of more than a majority of the corporation's shares.

It is possible that the nominal beneficiaries of the ESOP, the corporation's employees, will obtain little current benefit from the arrangement. This is true because, while the ESOP may own a significant percentage of the outstanding employer securities, a participant employee will not realize the value of the securities originally purchased by the ESOP until separation from service. Finally, because leveraged buyouts involve privately held corporations, the employees generally are entitled to only very limited voting rights with respect to ESOP stock.

Despite the uncertainty of the benefits that an ESOP confers on covered employees, in the 1984 Act Congress expanded the incentives for employee stock ownership through ESOPs in four ways: (1) banks, insurance companies, and other commercial lenders may exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock; (2) taxpayers are permitted to defer gain from the sale of stock to an ESOP if the proceeds are used to purchase stock in a second corporation; (3) corporations may deduct dividends paid to employees with respect to stock of the employer held in an ESOP or stock bonus plan; and (4) an ESOP may assume the estate tax liability with respect to stock of a closely held business which is transferred to the ESOP.

Historically, the employer's right to deduct ESOP contributions while the employees participating in the ESOP defer income has been a significant subsidy which has made the use of ESOPs a favored vehicle for leveraged buyouts. The 1984 Act, however, so enhanced the tax benefits available to leveraged ESOPs that we believe not only will the use of ESOPs in leveraged buyouts increase, but the total number of leveraged buyouts may actually increase. In addition, we expect that these new incentives will greatly increase the use of leveraged ESOPs to defend against potential takeovers.

The most significant of the new incentives for the use of ESOPs in leveraged buyouts is section 133 of the Code which permits banks, insurance companies, and other commercial lenders to exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock. This permits lenders to charge a lower interest rate and thus lower the costs of acquiring employer securities through an ESOP. We understand that the subsidy provided under section 133 allows qualifying lenders to provide financing to an ESOP at approximately 80 percent of the otherwise available interest rate. For example, if the rate available to the ESOP would be 10 percent without regard to section 133, the ESOP could save approximately $140,000 in interest charges on a ten-year, level payment, $1,000,000 obligation, assuming an actual interest rate of 8 percent. Such a significant reduction in the cash flow required to finance an acquisition is certain to stimulate leveraged buyouts.

The 1984 Act provisions also created an incentive for owners of businesses to sell to their ESOPs rather than to others. New section 1042 allows a shareholder to defer the gain on the sale of shares in the corporation to an ESOP if certain requirements are met. Presumably, the availability of deferral for a shareholder selling to an ESOP will result in a lower purchase price for the shares to the ESOP. Although our limited experience with this provision makes it impossible to know to what extent the special tax benefit to the selling shareholder will be reflected in the price to the ESOP, any reduction in the cost of acquiring a corporation through an ESOP will obviously create a further incentive for leveraged buyouts through ESOPs.

The cumulative effect of these subsidies is to create substantial tax incentives for leveraged buyouts through ESOPs. These benefits inure to those in a position to establish an ESOP and through that device to take a public company private. It also appears that ESOPs are frequently employed as a defensive takeover tactic. These tactics may have an unnecessary dampening effect upon otherwise advisable mergers and acquisitions. Although the goal of encouraging employee ownership may be worthwhile, we believe that any examination of mergers and acquisitions should include an examination of the effects on mergers and acquisitions of the indirect subsidies provided through the current tax provisions relating to ESOPs.

C. Overfunded Defined Benefit Plans

Concern also has been expressed recently about the involvement of overfunded qualified defined benefit plans in corporate mergers and acquisitions. Under current law, a company may terminate its defined benefit plan and receive any assets that are in excess of the present value of the participants' accrued benefits as of such termination. There are no restrictions on the company's use of such excess assets.

Because overfunded defined benefit plans thus constitute relatively attractive sources of cash, companies with significantly overfunded plans are thereby made more attractive takeover targets. There are several recent examples of acquiring companies terminating target companies' overfunded plans to partially fund the acquisitions. Also, it is not surprising that other companies have terminated their own overfunded plans to reduce the readily available pool of assets to which the companies have access and thereby to make themselves less attractive to other companies. These companies generally have used the excess assets to make less liquid investments (such as equipment purchases), to finance "going private" transactions, or to take defensive actions (such as establishing an ESOP to hold company stock) against potential takeover attempts. Finally, some companies have terminated their overfunded plans to use the assets offensively in their own takeover initiatives or to retire debt incurred in completed takeover transactions.

In assessing the role of defined benefit plans in mergers and acquisitions, one should understand the essential features of such plans and why and in what sense they are overfunded. The law grants favorable tax treatment to employer-maintained retirement plans that satisfy various qualification requirements. There are two types of qualified retirement plans: defined contribution plans and defined benefit plans. Under a defined contribution plan, a participant's accrued benefit is equal to the value of the assets allocated to such participant's account and all plan assets are allocated to participants' accounts. Thus, no assets are available for employer recoupment.

Under a defined benefit plan, however, the participant's accrued benefit is determined under a benefit formula, which generally is based on the participant's compensation and years of participation in the plan. The company maintaining the plan (the sponsor) has the responsibility to make sufficient contributions to the plan to maintain a pool of funds sufficient to provide the participants' promised retirement benefits as they come due. Accordingly, unlike a company maintaining a defined contribution plan, the sponsor of a defined benefit plan bears the full risk of investment gains and losses in the plan's assets.

There are numerous reasons why a defined benefit plan may, at any particular time, hold assets in excess of the present value of participants' accrued benefits at such time. The most basic reason is the inherent nature of the sponsor's obligation to fund a defined benefit plan, as reflected in the minimum funding standards of section 412 of the Code. These standards generally require that a sponsor fund the plan on a "going concern," rather than a "termination," basis. This means that sponsors must currently fund not merely accrued benefits, but also some portion of participants' projected benefits at normal retirement age. In projecting future benefits, future salary increases and inflation ordinarily are considered. In addition, in order to avoid an ever-increasing funding obligation as its workforce ages, a sponsor may choose to fund its plan in accordance with a level-funding actuarial funding method that tends to accelerate contributions relative to the rate of benefit accrual. As a consequence of the natural operation of the funding rules, a defined benefit plan that is not fully funded on a going concern basis may well be overfunded on a termination basis.

The actuarial methods commonly used in determining sponsors' defined benefit funding obligations rely on long-term assumptions regarding such items as investment returns and salary increases. To the extent that plan investments earn more than anticipated or salaries increase less than expected, overfunding will tend to be greater. For example, during recent years, the rates of return on equity investments have exceeded most actuarial assumptions, which themselves tend to be quite conservative, and salary increases have generally been less than expected.

Furthermore, in determining a defined benefit plan's excess assets, it is necessary to calculate the present value of participants' accrued benefits. The higher the interest rate assumption used in this calculation, the fewer assets are necessary to provide participants' accrued benefits. During recent years, insurance companies have been pricing both immediate and deferred annuity contracts for terminating defined benefit plans using recent high interest rates. By reducing the current cost of providing for participants' accrued benefits upon plan termination, this has contributed significantly to the excess termination-basis funding of many defined benefit plans.

Finally, within certain limits (section 404 of the Code), a sponsor is permitted to deduct defined benefit plan contributions in excess of the required contribution under the minimum funding standards. This may of course encourage further employer contributions to a plan, particularly in profitable years, and consequently larger overfunding.

The tax law requires a defined benefit plan to be maintained for the exclusive benefit of the participants and their beneficiaries. In addition, it must be impossible at any time

prior to the satisfaction of all liabilities with respect to the sponsor's employees and their beneficiaries under the plan, for any part of the plan's assets to be used for, or diverted to, purposes other than the exclusive benefit of the employees and their beneficiaries. Because it is not possible to satisfy all plan liabilities before plan termination, a sponsor may recoup plan assets only by terminating its plan. And, in this regard, because a sponsor may voluntarily establish a qualified plan and may voluntarily terminate its plan as it desires, this particular restriction rarely poses a practical obstacle.

A significantly overfunded defined benefit plan thus may be seen, both from the sponsor's perspective and from the perspectives of other companies that may be interested in attempting to take over the sponsor, as a relatively accessible and attractive pool of liquid assets. Of course, the desire to recoup excess plan assets is not limited to companies involved in merger and acquisition transactions. Any business need that requires significant financing--e.g., diversification, expansion of capacity, modernization, advertising--may be sufficient motivation. Nevertheless, due to the substantial cash requirements of acquisitions and acquisition-related transactions, it is natural that companies involved in such transactions will look to defined benefit plans as a potential source of ready funds.

While any assets received upon plan termination must be included in income, the sponsor is entitled to offset this inclusion by any available deductions and credits (including interest deductions and loss carryovers). Thus, because the decision to terminate is in the hands of the plan sponsor, it frequently is possible to time the termination so that none or only a small portion of the assets is subject to tax. To the extent a sponsor is able to achieve this result, terminating an overfunded defined benefit plan becomes more attractive.

One of the primary concerns expressed about the terminations of defined benefit plans to recoup plan assets is the security of the participants' benefits. Under current law, there is no requirement that participants continue to accrue benefits after a plan has terminated. It is thus inevitable that where a sponsor terminates a defined benefit plan and does not establish any other plan in its place, participants will not receive the benefits at retirement that they would have received--and may well have expected to receive--if the plan had not been terminated. In a voluntary pension system, there is very little that the government can do to prevent such terminations beyond assuring that all of the participants' benefits as of the termination are adequately provided.

Of greater recent concern, however, have been reversion transactions under which a sponsor receives plan assets while effectively continuing to maintain the defined benefit plan.

These transactions generally have taken two forms: (1) the termination of the defined benefit plan and the establishment of a new defined benefit plan, often identical to the terminated plan (reestablishment transaction); and (2) the spinoff of a defined benefit plan into two plans, one for active employees and one for retirees, the allocation of the excess assets to the retirees' plan, the termination of the retirees' plan, and the continuation of the defined benefit plan for the active employees (spinoff transaction).

In May 1983, the ERISA agencies (the Department of Treasury, the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation) issued enforcement guidelines (the Guidelines) for purposes of processing reestablishment and spinoff transactions. By requiring the full vesting of all benefits and the purchase of annuity contracts from insurance companies guaranteeing participants' accrued benefits, the Guidelines assure that the security of participants' benefits accrued before the transaction is not adversely affected. In addition, the Guidelines attempt to impose substantive parity between reestablishment transactions and spinoff transactions by requiring the continuing plan in the spinoff transaction to satisfy all of the substantive requirements of a formal termination--e.g., full vesting of benefits, formal notice to participants, and third-party annuitization of benefits. Moreover, the Guidelines extend additional security to plan participants in the continuing plans with respect to benefits accrued after the transactions by strengthening the funding requirements under such plans. Finally, the Guidelines prevent a sponsor from undertaking reestablishment and spinoff transactions on a regular basis by specifying that such transactions may not be undertaken more than once every fifteen years.

We believe that, within the confines of existing administrative authority, the Guidelines appropriately protect the interests of participants in plans that are involved in reestablishment or spinoff transactions. We recognize that some believe that additional protections are necessary, but we are comfortable that the Guidelines strike the proper balance between assuring the security of participants' benefits and not encouraging defined benefit plan sponsors to terminate their plans without establishing a successor plan. We do not believe that legislation with respect to these specific transactions is necessary.

Similarly, it is our view that the recent involvement of overfunded defined benefit plans in acquisitions and acquisition-related transactions does not warrant specific legislation to limit the rights of plan sponsors to terminate their defined benefit plans as they desire. We are concerned that any such legislative action to curb the termination of plans may

unnecessarily discourage employers from maintaining or properly funding defined benefit plans. We must be careful not to undermine the voluntary nature of the pension system in an attempt to dampen related merger and acquisition activity.

We recognize, however, that, in the context of a broader examination of pension and tax policy, it is appropriate to consider action to reduce the general incentive for plan sponsors to terminate plans and extract assets for nonretirement purposes. The impetus for any such action should not, however, be the involvement of overfunded plans in acquisition transactions--although this certainly would a factor to be considered--but rather should be based only on a full consideration of the applicable pension and tax policies. Thus, any proposal to reduce the incentive to terminate defined benefit plans should apply on an across-the-board basis, without regard to either the reason the sponsor is terminating the plan or the intent of the sponsor to establish a successor plan. For example, after further deliberations, it may be appropriate on pension and tax policy grounds to apply a special excise or minimum tax to asset reversions. This or similar action would reduce the attractiveness of terminating overfunded defined benefit plans in all circumstances.

D. Special Problems With Respect To Carry Over of Tax Attributes of Thrift Institutions

In the Economic Recovery Tax Act of 1981 ("ERTA"), Congress amended Section 368 of the Code to provide rules relating to bankruptcy reorganizations of thrift institutions (i.e., savings and loan associations and savings banks). These changes, proposed by the Federal Home Loan Bank Board (the "Bank Board"), were designed to resolve the issue of how the continuity of interest requirement applies in reorganizations involving thrift institutions.

Prior to ERTA, the Internal Revenue Service took the position that a merger of a stock association into a mutual association could not qualify as a tax-free reorganization. The Service reasoned that the exchange of the shareholders' stock for deposits in the mutual fails to satisfy the continuity of interest requirement because the deposits are cash equivalents. The courts generally rejected the Service's position, but without the concurrence of the Internal Revenue Service, combinations of stocks and mutuals could not be assured tax-free status.*/

*/ The Supreme Court recently sustained the Service's position in Paulsen v. Commissioner, ___ U.S. ___, 105 S. Ct. 627 (1985), ruling that the merger of a stock into a mutual does not satisfy the continuity of interest requirement. In this case, which arose prior to ERTA, the Court held that the interests of the former shareholders of the stock association in the mutual were essentially cash equivalents and, thus, the transaction failed the continuity of interest test.

There was also uncertainty as to the application of the continuity of interest requirement in reoganizations involving thrifts under section 368(a)(1)(G) ("G reorganizations"). In many reorganizations involving thrifts, the transferor's solvency was in question and the Internal Revenue Service took the position that the transaction could qualify as a tax-free acquisition only if it satisfied the G reorganization requirements. However, it was not clear how the continuity of interest requirement applied in a G reorganization involving thrifts. In the case of a mutual association there are no stockholders and the principal creditors are depositors whose interests generally are insured and who are not likely to exchange those claims for stock. Further, stock associations were unwilling to issue stock to those depositors. Consequently, it appeared that the continuity of interest requirement generally barred the reorganization of a thrift from qualifying as a tax-free G reorganization.

To resolve these issues, Congress lifted the continuity of interest requirement in G reorganizations involving a transferor thrift if certain requirements are met. Generally, under these rules, a transaction otherwise qualifying as a G reorganization, in which the transferor is a financial institution to which section 593 applies, will not be disqualified merely because no stock or securities of the transferee are issued, provided: (i) the transferee acquires substantially all of the assets of the thrift and the thrift distributes any remaining assets pursuant to the plan; (ii) substantially all of the liabilities of the thrift (including deposits) become liabilities of the transferee; and (iii) the appropriate agency certifies that, under 12 U.S.C. §1464(d)(6)(A)(i), (ii) or (iii), either that the transferee thrift is insolvent, the assets of the thrift are substantially dissipated, or the thrift is in an unsafe and unsound condition to conduct business. The Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC") or, if neither has supervisory authority over the thrift, the equivalent state authority may certify that one of the grounds specified in 12 U.S.C. §1464(d)(6)(A) exists. In addition, section 382(b)(7)(B) was added to provide that the transferee's and transferor's depositors are taken into account in determining the level of continuity of interest for purposes of section 381.

In these acquisitions a profitable financial institution typically agrees to assume the transferor thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to succeed to the transferor's tax attributes. The tax attributes which the acquiring corporation seeks to preserve are the thrift's accumulated net operating

losses and other carryforwards and the transferor thrift's basis in its assets (typically residential mortgages with basis significantly above fair market value).*/

In tax-free reorganizations the continuity of interest requirement limits tax-free treatment to those transactions in which the owners of the target corporation receive a meaningful ownership interest in the acquiring corporation. The transfer of stock in the target corporation for stock in the acquiring corporation is tax-free because the owners of the target corporation are deemed to have merely changed the form of their investment. Moreover, the notion that tax attributes carry over in a tax-free reorganization hinges on the continuity of interest doctrine. The tax law considers it appropriate for tax attributes to be used to offset income earned after the acquisition whenever the historic shareholders who incurred the unused attributes continue to hold a sufficient equity position after the reorganization.

Under the revised rules for thrifts, neither the stockholders nor the creditors (i.e., the depositors) of the troubled thrift receive a continuing ownership interest in the acquiring corporation. To permit tax attributes to carry over in these transactions thus departs from the traditional principles underlying the tax-free reorganization provisions, and provides a tax subsidy for private acquisitions of thrift institutions. In effect, this subsidy may operate to shift some or all of the burden of thrift losses from FSLIC, the private insurance agency funded by the thrift industry, to the Federal government. Congress thus should consider carefully whether subsidies for the thrift industry are necessary, and whether they should be made through direct appropriations or through the tax laws, recognizing that the latter route may be less efficient and more costly in the long run. We recognize, however, that the thrift industry is undergoing a period of restructuring and there may be nontax considerations for encouraging the flow of capital into the thrift industry.

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*/ This carryover basis would leave the transferee with substantial built-in losses which could be realized merely by selling the loans. Alternatively, if the transferee does not sell the loans, the carryover basis permits the transferee to treat payments other than stated interest as repayments of principal; if the transferee took a fair market value basis in the loans, a portion of the "principal" repayments would constitute market discount under section 1277 and thus be treated as ordinary income.

If the thrift reorganization rules are retained, we also suggest that these Committees examine whether the special thrift reorganization rules should be limited to acquisitions of a thrift by a bank or another thrift. These provisions were enacted to facilitate the rehabilitation of a thrift through its acquisition by another thrift under the supervisory powers of a certifying agency. Although the statutory language and the legislative history do not explicitly suggest that these provisions are limited to acquisitions of troubled thrifts by other depository institutions, strong concerns existed in 1981 that these special rules not be used to permit the ready transfer of realized and built-in losses of a troubled thrift to a corporation other than a depository institution. Indeed, the Bank Board, in seeking this legislation, assured the staffs of the tax-writing committees and the Treasury Department that the principal purpose of the legislation was to remove the technical obstacles to supervised mergers involving troubled thrift institutions.

We have become aware that these special rules are being used increasingly to facilitate mergers of troubled thrifts and corporations outside the banking sector. Though these acquisitions may technically satisfy the statutory requirements, the potential transfer of tax losses of troubled thrift institutions to corporations other than banks or other thrifts goes beyond the intended scope of the ERTA provisions. To date, the Internal Revenue Service has not issued rulings involving troubled thrifts where the principal trade or business of the acquiring corporation is unrelated to banking. Thus, if thrift reorganizations are to be continued, we urge that Congress clarify the scope of these provisions.

IV. Current Legislative Proposals

In response to the current flurry of merger and acquisition activity, a number of bills have been introduced in Congress that would use the tax laws to discourage these transactions. I will comment on several of these bills, but will not discuss any of them in detail.

It has been proposed that more stringent tax consequences attach to a stock acquisition that is effected pursuant to a hostile takeover (generally, one disapproved by a majority of the independent members of the board of directors of the target corporation). An automatic section 338 election would be deemed made, and all gain on the target corporation's assets, not just recapture and tax benefit items, would be recognized. We do not believe that the tax laws should be used to discourage hostile takeovers. If it is concluded that hostile takeovers harm shareholders or the economy, Congress should address its concerns directly. As a matter of tax policy we do not believe "hostile" acquisitions should be treated differently under the tax laws than "friendly" acquisitions.

It has also been suggested that so-called "greenmail" profits be subject to a 50 percent excise tax, and that no deductions be allowed for "greenmail payments" or interest on indebtedness incurred to acquire stock or assets acquired pursuant to certain hostile acquisitions. While we would not object to a statutory confirmation that under current law "greenmail payments" are not deductible, we do not believe, that there is a need for special tax provisions to curtail greenmail payments.

V. <u>Summary</u>

In conclusion, the current tax rules would not appear to be propelling the recent surge of corporate acquisitions and takeovers. We have set out in this testimony, however, certain aspects of current tax law that may encourage corporate acquisitions and that may be the proper subject of legislative reforms in this area. In particular, we look forward to working with your Committees this year to modify the rules relating to the carry over of corporate tax attributes in mergers and acquisitions. We do not believe, however, that Congress should amend the tax laws for the purpose of generally discouraging merger and acquisition transactions.

* * *

This concludes my prepared remarks. I would be happy to respond to your questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 8:30 A.M.

STATEMENT OF BERYL W. SPRINKEL
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WASHINGTON, D.C.

Tuesday, April 2, 1985

Mr. Chairman, distinguished members of the Committee, it is an honor for me to appear before you today as the President's nominee to be Chairman of the Council of Economic Advisers.

During the past four years, it has been my privilege to serve as the Under Secretary of the Treasury for Monetary Affairs. In that capacity, I have been involved in a wide range of domestic and international economic issues and have worked closely with officials from other Executive agencies, the Congress, foreign governments and international agencies. The experiences I have had and the personal relations that have evolved have resulted in a most rewarding and satisfying four years. In particular, I have appreciated and enjoyed the opportunity to participate on many occasions in this Committee's semi-annual review of monetary policy.

When President Reagan came to office in 1981, a primary goal was to revitalize the U.S. economy which was overburdened by the effects of record high inflation and interest rates, rising tax rates and proliferating government regulations. The President's economic recovery program did not seek cosmetic, short-run relief to our economic ills. Rather, it was designed to put in place prudent, long-term economic policies designed to reduce inflation and provide for sustainable real economic expansion. We are now enjoying the fruits of those long-term policies.

Inflation in the past three years has been lower than during any time since the mid 1960's. Interest rates are well below where they were in January 1981. We are into the third year of an economic expansion which to date has been the strongest in 30 years. Business investment is booming, productivity is up, and the proportion of the adult population that is at work is at a peacetime high. In contrast to the late 1970's, the U.S. economy is again the envy of the world.

Our efforts to restore sound, noninflationary growth in the U.S. have provided an important stimulus to growth in other countries. We believe we have learned some important lessons about the effects of providing positive incentives and allowing free markets to work. These same principles can help other nations improve the dynamism and flexibility of their economies. Other Administration officials and I have worked closely with our foreign counterparts to encourage the design of policies that will promote noninflationary economic growth on a global scale.

The restoration of a strong U.S. economy has been reflected internationally in both a strong dollar and a growing trade and current account deficit. At the same time, the strong recovery in the U.S. and the strength of the dollar have provided considerable stimulus to European economic recovery and the growth in LDC exports. We anticipate that efforts to restore growth in other countries -- with our encouragement -- will also help to strengthen foreign currencies relative to the dollar and improve our trade position. We have also emphasized that increased international access to markets plays an important role in contributing to global growth.

Another key international economic issue has been the debt crisis and the stability of the international financial system. The restoration of economic growth in the industrialized countries and sound adjustment efforts by the developing countries themselves have been two key elements of our approach to these problems. The economic situation in the developing countries has improved in the past two years, although we still have some way to go before this problem can be put behind us.

Another key area of responsibility for me at Treasury has been debt management. We have pursued debt management policies which, while achieving the immediate objective of providing necessary funds, also served to balance the Treasury's financing activities in the market and contribute to the liquidity and breadth of the government securities market. We introduced rather innovative financing techniques which we believe have expanded the investor base for Treasury securities, while minimizing the cost of financing to the government and the taxpayer. In addition, our efforts are ongoing to modernize cash management and processing procedures within Treasury and throughout the Federal government. By 1988, annual interest savings will have grown to $3.5 billion. In total, over five years these efforts are expected to save the taxpayer $9.1 billion.

This is a solid record of accomplishment for us all and the credit must be shared among the Administration, the Congress and the Federal Reserve. Obviously, problems and challenges remain.

One of our biggest challenges is to get the Federal deficit on a downward path. With outlays and tax revenues still close to their historic highs, we believe it is best for the economy if we accomplish this through spending restraint, along with sustained economic growth. This will enable us to reduce outlays gradually

as a share of GNP, until they are brought more nearly into line with the rising revenues which economic growth will generate. I know that all of you, along with your colleagues, are working hard to restrain spending growth and reduce the budget deficit in a way that is fair to all Americans. We in the Administration appreciate your commitment and are confident that with perseverance an acceptable, bipartisan solution can be found.

The Administration is also committed to working with the Congress on a fundamental and comprehensive tax reform plan. Our goal is a simpler, fairer system, one more conducive to economic growth, and one which will eliminate the tax burden on taxpayers at or below the poverty level.

It is critically important that monetary policy be designed to protect the progress on inflation and ultimately to reduce the inflation rate further. Inflation is a pervasive deterrent to a healthy and prosperous economy. Our commitment to restoring price stability must not waiver and it is important that our monetary actions consistently convey that commitment to the financial markets. Monetary policy at the same time should provide sufficient money growth to support sustained economic growth and avoid any undue monetary restriction of the economy.

These and other issues are the tough decisions and challenges the President and all of us will face in the months and years ahead. I know the members of this Committee share our desire to formulate economic policies that provide price stability and enhance economic growth and opportunity. If confirmed as CEA Chairman, I look forward to working closely with this Committee and the Congress in that economic policymaking process.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.

April 2, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,300 million, to be issued April 11, 1985. This offering will result in a paydown for the Treasury of about $50 million, as the maturing bills are outstanding in the amount of $13,338 million, including $625 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities and $2,285 million currently held by Federal Reserve Banks for their own account. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,650 million, representing an additional amount of bills dated July 12, 1984, and to mature July 11, 1985 (CUSIP No. 912794 HJ 6), currently outstanding in the amount of $15,650 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,650 million, to be dated April 11, 1985, and to mature October 10, 1985 (CUSIP No. 912794 JB 1).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing April 11, 1985. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Standard time, Monday, April 8, 1985. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit

of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on April 11, 1985, in cash or other immediately-available funds or in Treasury bills maturing April 11, 1985. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

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STATEMENT OF
THE HONORABLE
JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS OF THE
COMMITTEE ON APPROPRIATIONS
U.S. SENATE
APRIL 4, 1985

Mr. Chairman and members of the committee:

It is a pleasure to meet with you today to discuss the policies we are pursuing with the Multilateral Development Banks (MDBs); the President's budget proposals for the MDBs; and the compelling need for this Committee to support the replenishments recently negotiated which reflect full consultation with the Congress, and in particular, this Committee.

The Administration firmly supports the MDBs and their vital role in preserving and enlarging the international economy by providing technical and financial assistance to developing countries. Mr. Chairman, I agree with your remarks to Secretary of State Shultz two weeks ago: the United States has a long-term self-interest in nurturing these institutions.

You and the members of your committee played a key role in securing Congressional approval for the Seventh Replenishment of the International Development Association (IDA VII) and the newly created Inter-American Investment Corporation (IIC). The Administration deeply appreciates your invaluable help in implementing the President's program.

Successful United States leadership in these institutions depends on firm backing by the Congress for international commitments -- commitments made on the basis of extensive congressional consultations. The President -- indeed, our country -- stands behind those commitments. Having played a part in the preparations for these negotiations, you now bear responsibility for following through on these replenishment commitments so that the MDBs may more fully serve the people for whom they were created.

The basis for our participation and policy direction will continue to be the 1982 Treasury assessment of the MDBs which this Committee helped to shape. As you will recall, the assessment concluded that the MDBs have been most useful to

the United States by contributing to the achievement of our global economic and financial objectives, and also helping us to advance our long term political and strategic interests. This is more true today than in 1982. The situation in Sub-Saharan Africa, for instance, has steadily deteriorated since 1982. There is a need for major programs of policy reform and on getting better value from both internal and external resources. The economies of Latin America are striving to get back on their feet from the debt crisis that struck in 1982. In both these geographic regions, as well as Asia, the MDBs are playing an important role in enhancing developing country growth and stability:

-- as catalysts for mobilizing private sector resources;

-- as sources of sound economic policy advice and technical assistance; and

-- as providers of inputs that the private sector would not or could not provide.

The Administration's specific objectives, also in keeping with the assessment, are to hold down the budgetary impact of the MDBs, promote better quality loans, and enhance the role of the private sector. We want to stop the practice of viewing the quantity of lending as a mark of success in these institutions by refocusing our attention to the issue of the quality of MDB lending.

Reducing Budgetary Impact of the MDBs

As a fiscal year 1985 supplemental we are requesting $236.7 million in budget authority and $1,219.0 million for callable capital, which as you know, is provided in the form of program limitations. The fiscal year 1986 request is for $1,347.6 million in budget authority and $3,641.7 million for callable capital.

In the past, members of this committee have supported the Administration in its efforts to scrutinize the budgetary effects of the MDB programs consistent with U.S. interests and the realities of our domestic budget environment.

In fact, our current fiscal year 1986 budget request for paid-in capital and concessional funding is $130.5 million or 8.8 percent less than was provided in fiscal year 1980. Since taking office this Administration has negotiated replenishments that have reduced the proportion of paid-in capital for subscriptions to the hard-loan windows of the MDBs. In the Inter-American Development Bank (IDB), paid-in capital is now 4.5 percent of the total, down from 7.5 percent in the previous capital increase. In the Asian Development Bank (ADB), paid-in capital dropped from 10 to 5 percent. The IBRD dropped the amount of paid-in capital from 10 to 7.5 percent.

Because of their greater budgetary impact, the reduction in the budget request has come from a decrease in the MDBs' soft loan programs; these programs have been reduced some $570 million, or 40.5 percent in real terms, in our FY 1986 request compared to the FY 1981 programmed levels. The current experience of the MDB soft windows in processing loan commitments indicates that the replenishments the Administration negotiated were adequate, including the three-year $750 million per year IDA VII replenishment. However, even after the reductions that have taken place the programs remain sufficiently substantial to fulfill their objectives.

I would like to take a few minutes to address the single largest component of our budget request for the MDBs--the International Development Association (IDA). We are pleased that the World Bank has moved swiftly to strenghthen the administration and management of its African operations with the object of supporting policy reform efforts in this region. IDA, with its enhanced efforts to increase effectiveness of its lending to Sub-Saharan Africa, will be focusing its program on the need for appropriate policies that are essential to achieve self-sustaining growth. The share of IDA's resources going to Sub-Saharan Africa has increased from an average of 27.5 percent in 1980 through 1982 to 35.2 percent in the subsequent years.

This Committee has been most outspoken on the subject of India borrowing from IDA. India had been receiving a full 40 percent of all IDA credits. India's share dropped to 28.0 percent by fiscal year 1984 and is expected to decline further during IDA VII.

Because of the scope and effectiveness of its lending operations IDA is the single most important multilateral development institution for the World's poorest countries, many of which are in Sub-Saharan Africa. The Administration -- after extensive consultation with this Committee -- made a commitment to the institution and the developing countries to contribute $750 million in FY 1986. We must honor this commitment, along with the other commitments that have been made to the MDBs in consultation with Congress.

Consistency with Bilateral Assistance

We sometimes hear the argument that bilateral assistance is a better vehicle for advancing U.S. foreign policy interests in developing countries. We believe the programs are interrelated and that both are effective channels for assisting developing countries. U.S. financial support of the MDBs is matched by substantial amounts from other donor countries and private capital markets; U.S. bilateral programs engender close cooperation that enhance our national interest and increase political, economic, and military stability in the third world.

The Committee may find of interest that out of 37 countries that received allocations in 1984 from the State Department's Economic Support Fund (ESF), the MDBs lent to 32 of them. Another three -- Israel, Italy, and Spain -- have per capita GNPs too high to qualify as MDB borrowers. Among these 32 countries receiving MDB assistance, the United States provided $6.7 billion in foreign aid in 1984, while the MDBs provided $4.9 billion to these same countries -- at a cost to the United States of approximately $1.3 billion because of the unique cost sharing features of these institutions. In short, the MDBs are cost effective in assisting countries of particular importance to the United States.

Improved Loan Quality

We have also achieved better quality loans. This is evidenced in several areas. First, we have had success in the MDBs with our efforts to strengthen the quality of loans. Occasionally this may require the United States to oppose a loan based on an assessment of the economic viability of the project.

I think it is fair to say that there has been some improvement in the overall quality of MDB lending as a result of our continuing emphasis on this subject. We have been particularly concerned about MDB lending for projects which are likely to achieve high financial rates of return, and which could be undertaken by the private sector or with commercial finance.

An example of our success in strengthening MDB lending policy is the change in World Bank project lending for oil and gas projects. Early in this Administration we successfully opposed the creation of a special World Bank Energy Affiliate because we believed it to be unnecessary. In addition, we have opposed a number of loans in this sector because we believed the World Bank was displacing private capital available for this purpose. Our concerns did not go unnoticed. Recently the World Bank issued new operating guidelines that should significantly improve the quality of their lending in this sector.

Another example of improved loan quality is the continuing priority given to economic policy adjustment issues in the face of declining loan demand. The World Bank's lending in its current fiscal year is now projected at $11 billion -- roughly $2 billion less than the IBRD anticipated. We fully support the World Bank's recently increased emphasis on maintaining lending standards rather than pursuing aggregate lending targets.

A final illustration of improved loan quality concerns public utility tariffs at the Inter-American Development Bank (IDB), where we were successful in attaining a significant policy change. With this policy in place the IDB can only now make loans to public utilities that have a rate structure which

enables the utility to meet full operating and maintenance costs. This policy will result in a reduction in government budget subsidies for those countries receiving loans in these sectors.

Environmental Impact of MDB Projects

An area where we are now trying to influence MDB policy to be more constructive is the impact of MDB projects on the environment. I am well aware, Mr. Chairman, of your deep concern on this issue, particularly regarding some MDB projects in Brazil. I share your concerns. Your public expressions have very usefully focused attention on this issue. Our own examination of MDB projects indicates a mixed performance by the Banks in adhering to their own, current standards regarding environmental safeguards on the design and implementation of their projects. There have been some very well designed projects; there has also been a number of environmentally questionable projects.

To address this situation Treasury is undertaking a policy of bringing questionable projects to the attention of senior Management of the various MDBs. The impact of accumulating evidence will bring home the conclusion that policy implementation has to be strengthened.

As we all become more aware of the environmental impact of MDB projects -- donors, recipients, and the institutions themselves -- we will have to become more careful in analyzing this factor.

In the meantime, Mr. Chairman, the U.S. Treasury welcomes hearing from you and other members of your Committee regarding the adverse environmental impact of any MDB projects that might come to your attention.

Support for the Private Sector

We also have as a general goal to increase MDB support for the private sector.

Your Committee, Mr. Chairman, has already contributed much toward support for the private sector by lending a firm hand in enacting legislation to enable U.S. participation in the Inter-American Investment Corporation (IIC).

Most IDB members have joined together to create the IIC which will be linked with the IDB. The IIC will focus on strengthening the capitalization of small- to medium-sized firms in Latin America and the Caribbean by providing equity participations and loans.

Other MDBs have also taken some positive steps in this direction. As I will mention in more detail later, the International Finance Corporation (IFC) is about to embark

on a five-year plan to boost their support for the private sector. About two years ago the ADB began equity operations on a small scale. In addition, the ADB recently held a seminar on "privatizing" -- i.e., having the private sector perform certain functions now performed by the public sector, often through state-owned enterprises (SOEs). We are looking forward to reviewing the seminar's final results, and for ADB management to carry them forward in a policy paper.

We are carefully examining the MDBs' past practices in lending to state-owned enterprises, particularly to ascertain the extent of private sector alternatives. We do so because we believe State-owned enterprises are frequently plagued by management deficiencies, and political pressures to sustain artificial levels of employment and subsidized prices. Therefore, it is imperative to strengthen the private sector in these economies. Our thinking on this matter is still in its early stages, and your ideas on this subject are most welcome.

U.S. Unfunded Replenishment Commitments

The Administration's FY 1985 Supplemental Request reflects our determination to honor United States' commitments to the institutions, the other donor countries, and most importantly, to the people of the developing countries themselves -- commitments for the most part negotiated by this Administration.

I believe our unfunded replenishment commitments are truly creating a very difficult situation for MDB lending programs. Currently, the United States' funding shortfall of $91 million in the Asian Development Fund (ADF) has, because of a cost sharing mechanism, led to total reductions of about $250 million. Without our requested funds, the ADF will be forced to make contingent loan commitments, which prevents the institution from finalizing their loan agreements.

The Inter-American Development Bank (IDB) is in a worse situation. Because charter provisions grant the United States 34.5 percent of the IDB voting power, the Bank cannot accept subscriptions from others that would push us below this level. Based on this 34.5 percent criterion, the current U.S. shortfall in subscriptions of $40 million paid-in capital and $849 million in callable capital compels the IDB to refuse to accept subscriptions from other members of more than $1.67 billion. This has forced the IDB to stop its regular lending and only make contingent commitments until we provide our subscription shortfall.

The last replenishment of the IDB's soft loan window, the Fund for Special Operations (FSO), also contains a cost sharing mechanism. Our shortfall of $72.5 million has resulted in a total shortfall of around $175 million. The unfunded commitments to the World Bank's General Capital Increase (GCI) has temporarily pushed our voting power to

below 20 percent. The first installment for the Inter-American Investment Corporation (IIC) remains incomplete and detracts from our efforts to urge others to join up.

I strongly believe that consistent shortfalls can cause serious damage to our relations with other member countries, the institutions themselves, and more importantly, have a negative impact on the people of the developing countries who are the beneficiaries of these institutions. On the basis of our extensive consultations with the Congress, including this Committee, we entered into commitments we believed the United States would be able to honor. We now find ourselves unable to fulfill the obligations we agreed to. Frankly, this is not good government, and, does not speak well for the United States.

The Fiscal Year 1985 and 1986 Budget Request

With the exception of a small number of capital shares in the World Bank dating back to 1970 which the United States did not purchase, and capital shares for the IBRD's 1981 General Capital Increase (GCI), the entire MDB fiscal year 1986 request comprises replenishment agreements negotiated by this Administration in close consultation with this Committee.

Treasury officials kept in close touch with the Committee and these funding proposals reflect both the need for budgetary restraint and the financial requirements for effective development programs. We are requesting $236.7 million in budget authority and $1,219.0 million under program limitations for callable capital subscriptions as a fiscal year 1985 supplemental. The fiscal year 1986 request is for $1,347.6 million in budget authority and $3,641.7 million under program limitations for callable capital.

Many of the countries in Sub-Saharan Africa are in serious economic difficulty. It is worth noting, therefore, that many of the programs included in this request are oriented toward this region. An increased share of IDA resources go to Sub-Saharan Africa; the African Development Bank and Fund are devoted entirely to promoting the region's development; and the International Finance Corporation's new five-year plan features increased emphasis on the region.

International Bank for Reconstruction and Development (IBRD)

For the IBRD, the Administration is seeking a fiscal year 1985 supplemental request of $30.0 million in budget authority for paid-in capital and $370.0 million under program limitations for callable capital to complete the fourth of six installments for the U.S. share of the 1981 GCI of the Bank. For fiscal year 1986, the Administration is requesting: 1) $109.7 million in budget authority and $1,353.2 million under program limitations for subscriptions to the fifth installment of the 1981

GCI; 2) $65.7 million in budget authority and $685.3 million under program limitations for subscriptions to the first of two installments to the IBRD's 1984 Selective Capital Increase (SCI); and 3) $7.4 million for paid-in capital subscriptions and $66.9 million in program limitation for callable capital subscriptions to the 1970 SCI.

The 1984 SCI totals $8.4 billion and was unanimously approved by the IBRD Executive Board in May 1984. This SCI adjusts members' relative shares to reflect their relative position in the world economy. U.S. participation is an important demonstration of U.S. support for the World Bank and our willingness to work cooperatively with other donor countries to strengthen the World Bank's financial position and ensure improved cost-sharing.

The Administration continues to believe that the IBRD should play a prominent role in the longer-term development programs of its borrowers and regards "equitable cost-sharing" among donors to be a key element of our participation in all of the MDBs. An important consideration for the United States in negotiating the SCI was the general understanding to maintain a conservative interpretation of the IBRD's "sustainable level of lending" (SLL).

Subscription to all IBRD shares -- the GCI and both SCIs -- is essential in order to maintain the U.S. veto over amendments to the Articles of Agreement of the Bank.

International Development Association (IDA)

For fiscal year 1986, the Administration is requesting $750 million for the second of three installments for the $2.25 billion U.S. share of the $9 billion seventh replenishment. We are pleased at the speed with which the World Bank has moved, with full support of the Executive Board, to strengthen the administration and management of its African operations, with the object of supporting policy reform efforts in this region. We continue to believe the countries of Sub-Saharan Africa and other least developed countries should have first claim on available IDA resources as long as these countries are able to make effective use of these resources.

International Finance Corporation (IFC)

For fiscal year 1986, the Administration is seeking $35.0 million for the first of five installments on the U.S. subscription to a $650 million IFC capital increase unanimously approved by the IFC Executive Board in June, 1984.

This capital increase is needed to support an IFC five-year plan for the period FY 1985-1989 that features four initiatives:

1) increased emphasis on capital market development to build the institutions necessary to mobilize capital;

2) implementation of a corporate restructuring program to assist enterprises adapt to changing economic conditions brought about by adjustment programs and adverse or changing market conditions;

3) allocation of a larger share of IFC's resources to Sub-Saharan Africa for a program which contains four main components:

   - provide investment analysis and advisory services through expanded venture capital companies;

   - take a larger investment share where it proves difficult to mobilize resources for otherwise worthwhile projects;

   - more and smaller projects to take advantage of the region's relatively larger number of smaller scale investments; and

   - more intensive use of development finance corporations.

4) establishment of an energy exploration and development program that will attract foreign private resources to developing countries.

This investment program is consistent with the direction and emphasis the United States has encouraged the IFC to take.

Inter-American Development Bank (IDB)

In a supplemental request for fiscal year 1985, the Administration is seeking $40.0 million in budget authority and $849.0 million under program limitations for subscriptions to complete the second of four installments to the 1983 capital increase of the IDB. For fiscal year 1986, the Administration is requesting $58.0 million in budget authority and $1,231.0 million under program limitations for the third installment. The lending program based on the 1983 capital increase is designed to continue strong support for the long term development of the countries in Latin America and the Caribbean.

Fund for Special Operations (FSO)

In a supplemental request for fiscal year 1985, the Administration is seeking $72.5 million for the second of four installments for the 1983 replenishment. For fiscal year 1986, the Administration is requesting $72.5 million for the third installment.

The FSO replenishment is designed to address the long term development needs of the poorest countries, primarily in Central America and the Caribbean. As a result of U.S.

unfunded commitments to the FSO, other countries are also holding back on their payments.

Inter-American Investment Corporation (IIC)

In a supplemental request for fiscal year 1985, the Administration is seeking $3 million to complete the first of four installments for the initial U.S. subscription to the IIC. For fiscal year 1986, the Administration is seeking $13 million for the second installment.

The Administration strongly supported establishing the IIC as a practical means of enhancing the capacity of the IDB to aid the private sector in borrowing countries. The investment program will provide loans and equity participation for small- to medium-sized privately controlled firms in Latin America and the Caribbean.

Asian Development Bank (ADB)

For fiscal year 1986, the Administration is seeking $13.2 million in budget authority and $251.4 million under program limitations for the third of five installments for the 1983 General Capital Increase.

The ADB is a key institution in one of the most economically dynamic and politically sensitive regions of the world. Active and positive U.S. participation has served U.S. interests.

Asian Development Fund (ADF)

In a supplemental request for fiscal year 1985, the Administration is seeking $28.2 million to complete U.S. contributions to the first replenishment and $63 million to complete the second of four installments to the third replenishment. For fiscal year 1986, the Administration is requesting $130 million for the third installment to the third replenishment.

The ADF has supported well designed and effective development projects in some of the poorest countries in the world. U.S. support benefits the people of such countries as Pakistan and Sri Lanka as well as many of the strategic island countries in the Southern Pacific.

African Development Bank (AFDB)

For fiscal year 1986, the Administration is requesting $18.0 million in budget authority for subscriptions to paid-in capital and $54.0 million under program limitations for callable capital for the fourth of five installments for the initial U.S. subscription to the AFDB.

The AFDB is visible evidence of U.S. commitment to work with the countries of Africa for the achievement of their long term development objectives.

African Development Fund (AFDF)

For fiscal year 1986, the Administration is seeking $75 million in budget authority for the first of three installments for the U.S. contribution to the fourth replenishment.

During the period of the fourth replenishment, 85 percent of AFDF lending will go to the poorest African countries. Fund lending will continue to be focused on agriculture with 40 percent of the replenishment resources going to this sector. The remainder of AFDF lending will go to high priority projects for transportation, health, education and water supply.

The substantial increase in the U.S. contribution to the AFDF is a reflection of the Administration's belief that concessional development assistance should be focused on the poorest countries, particularly those of Sub-Saharan Africa.

Upcoming Replenishment Negotiations

It may be useful to briefly comment on upcoming replenishment negotiations. In light of the current severe fiscal pressures, the Administration has not budgeted at this time for all future replenishments. Because of the budget stringency all current programs -- domestic and international -- are being thoroughly scrutinized for possible budgetary cuts. In this context we decided to defer any decisions on future participation until later in the year.

The replenishment negotiations that will begin this year are for the ADF, IDB/FSO and AFDB. Negotiations for IDA VIII will commence in late 1985 or early 1986 and should be completed in time for IDA to begin making commitments in July 1987. We plan to consult with this Committee, as well as others, to inform you about these upcoming replenishment negotiations in more detail.

Conclusion

In conclusion, Mr. Chairman, I want to emphasize this Administration's commitment and full support for the MDBs. In this context, I reiterate the importance of the supplemental request for contributions and subscriptions that we have requested previously, and to urge your full support for the entire FY 1986 budget request.

The supplemental request is, for the most part, to complete installments for agreements negotiated by this Administration. Failure to provide previous amounts requested has significantly curtailed the lending programs of the ADF and FSO. The IDB lending program is essentially stopped. Obviously the FY 1986 budget request must be appropriated in full to prevent a continuation of these shortfalls.

As you know, Mr. Chairman, the Administration made an earnest effort to consult closely with the concerned members of the Congress in conducting our 1982 Assessment of the MDBs and the replenishments negotiated on the basis of the Assessment's guidelines. Moreover, President Reagan, in various international fora, has repeatedly stressed U.S. commitment to these institutions. Now, we urge your support for the Administration's MDB request so that the people for whom these institutions were created to serve will benefit.

TREASURY NEWS

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STATEMENT OF THE HONORABLE JAMES A. BAKER, III

SECRETARY OF THE TREASURY

COMMITTEE ON APPROPRIATIONS

SUBCOMMITTEE FOR TREASURY, POSTAL SERVICE,

AND GENERAL GOVERNMENT

MR. CHAIRMAN, MEMBERS OF THE SUBCOMMITTEE:

I am pleased to appear before this Subcommittee for the first time to discuss the operating budget for the Treasury Department for Fiscal Year 1986.

As this Subcommittee is well aware, and as I have come to understand better during the past several weeks, the Treasury Department carries out functions that are truly essential to the existence of our Federal system of government. We administer the Nation's tax system, and collect the government's revenues. We manage the government's fiscal affairs, including paying its bills and financing the nation's public debt. We manufacture the currency and coin that are essential to the nation's commerce and economic well-being. We help regulate our country's financial institutions. We process passengers and cargo coming into the

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country, enforcing import and export laws. We carry out basic federal law enforcement responsibilities, including protecting the President, Vice-President, as well as other dignitaries. We participate in the effort to combat illegal drug smuggling, and administer firearms and explosives laws. Finally, we advise the President on monetary, economic, and tax policies.

To continue to carry out the functions of the Treasury Department in Fiscal Year 1986, we are requesting a total budget of $5.3 billion and 121,006 positions. These funding and staffing totals include $6 million and 75 positions for the administration of the revenue sharing program; that request is reviewed by the Appropriations Subcommittee for Housing and Urban Development and Independent Agencies.

Our budget request for FY 1986 represents a decrease of $45 million, or 0.8%, below the comparable Fiscal Year 1985 levels.

In addition to these funding and staffing requests for the operations of the Treasury Department, our Fiscal Year 1986 budget reflects a proposed transfer of certain responsibilities of the Small Business Administration to the Treasury Department.

Our budget includes $74 million and 1,650 positions for the administrative costs of servicing existing direct loans and monitoring the servicing of guaranteed loans. The budget also includes $2.6 billion for expenses directly associated with the portfolio, including writing off defaulted loans. Our understanding is that this request concerning the transfer of the Small Business Administration will not be taken up by the Treasury Appropriations Subcommittee, but will be covered by the Commerce, Justice, State and Judiciary Subcommittee.

The Fiscal Year 1986 budget for the Treasury Department has several major objectives. First, the overall budget request reflects our participation in the governmentwide 1-year freeze in total spending other than debt service. Specifically, we have maintained spending levels appropriated in the Fiscal Year 1985 Continuing Resolution plus critical supplemental requests.

Second, our budget reflects two specific governmentwide proposals included in the President's budget -- a reduction of 5% in Federal civilian pay effective January, 1986, and a 10% reduction in administrative and overhead costs.

The 5% pay reduction will produce savings of approximately $135 million in the Treasury Department's budget for Fiscal Year 1986.

To accomplish the 10% reduction in administrative costs, we will streamline administrative and support operations. Every Treasury organization will participate in this effort; the estimated savings in Fiscal Year 1986 is $64 million. The majority of these savings will be accomplished in the Internal Revenue Service and the U.S. Customs Service. The IRS reduction reflects cuts in personnel, printing, and general support operations. The reduction in the U.S. Customs Service reflects the centralization of administrative functions, certain organizational realignments, and various operational and management efficiencies.

Strengthening law enforcement capabilities is a third objective of this budget.

We will increase our participation in the President's Organized Crime Drug Enforcement Task Forces. We are requesting supplemental funding of $6.5 million in Fiscal Year 1985 to support Treasury's participation in the 13th City Task Force in Miami. These Task Forces have achieved dramatic results. Since October of 1982, the Task Forces have initiated over 800 cases, which have resulted in over 4,300 indictments and more than 1,600 convictions. Over two-thirds of these cases have been the direct result of financial investigations. These efforts have focused on the criminal leadership in this country; this has resulted in the breakup of many formerly well-financed and tightly-controlled organized crime operations.

We are moving to strengthen our drug interdiction efforts. We will acquire three additional P-3A aircraft this summer for surveillance. We have recently completed the installation of a third air-to-air surveillance aerostat in the Bahamas. Further, we will acquire eight new, high endurance, tracking aircraft this year with funds appropriated in FY 1984.

Our Fiscal Year 1986 budget for air interdiction represents an increase of $16 million, or 36%. These funds will be used to operate the P-3A aircraft to be acquired this summer, to install radars and night vision devices in certain interception aircraft, to operate up to two additional helicopters, and to begin developmental work on a 360 degree search radar system.

The Treasury Department is most appreciative of the assistance we have received from the Defense Department over the past several years in our efforts to stem the flow of illegal drugs into the country. As I am sure you are all aware, the drug traffic from Central and South America, through the Caribbean, is an increasingly serious problem. Treasury must do everything that we can to work together with all Federal agencies who can aid in this war on drugs. To this end, I am asking the Assistant Secretary of the Treasury for Enforcement and Operations to meet

with the Defense Department to develop a joint plan for strengthening our anti-smuggling capabilities in the Caribbean Basin.

Our budget contains a proposed Fiscal Year 1985 supplemental of $4.1 million to provide security and related equipment for the perimeter of the White House, Naval Observatory, and Main Treasury. We believe that these improvements are critical due to the recent events world-wide and the increased threat of terrorist activity in this country.

In order to provide improved handling of seized property, we are requesting $6 million in Fiscal Year 1985 and $8 million in Fiscal Year 1986 for a new Customs Forfeiture Fund. This Fund was authorized by Congress last year in both the Trade and Tariff Act of 1984 and the FY 1985 Continuing Resolution. The Fund operates using the net proceeds from the disposition of seized and forfeited merchandise and currency. We will use the Fund primarily to pay for expenses related to seizures and to equip forfeited vessels, vehicles, and aircraft for use in narcotics interdiction. We believe that this Fund not only will enable us to increase significantly the profits from the sale of seized assets, but also will increase the equipment available to us for drug interdiction.

A fourth major objective of this budget is to continue major efforts to modernize Treasury systems and equipment. Even within an overall spending freeze, we cannot postpone the introduction of new technology and modern equipment. These investments are essential to the Department's ability to handle growing workloads and to relieve future pressures for growth in personnel.

To help modernize the tax administration system, our budget includes resources to continue two major projects now under development -- the Automated Examination System and the Tax System Redesign Project. The Automated Examination System will equip IRS enforcement personnel with modern equipment to help them in the auditing of tax returns. When this system is fully implemented, productivity is expected to increase by as much as 25%. The Tax System Redesign Project is a longer-term effort to enable IRS to create an overall modernized system that will meet the requirements of the 1990's.

The U.S. Customs Service is seeking an additional $14 million to automate its major commercial processing procedures, to develop an integrated data telecommunications network, to replace the current 15 year old Treasury Enforcement Communications System, and to apply new technology to drug interdiction efforts. Customs' Automated Commercial System will

involve automated processing of entries from the trade community, eliminate redundancies, reduce paper, and enhance selectivity procedures in the cargo review process.

The Department's fiscal bureaus will continue to improve the government's financial systems, the means by which we collect, manage, and disburse federal funds and finance the public debt. The Financial Management Service is requesting an additional $14 million to complete replacement of the Service's headquarters computer, continue efforts to upgrade the government's collection and payment systems, and enhance the financial telecommunications network. The Bureau of the Public Debt is requesting $3.5 million for funding for the first phase of a project to replace the Bureau's mainframe computer and to purchase new equipment for the processing of Savings Bonds issue stubs.

A fifth major objective of this budget is to strengthen the tax administration system to collect additional revenues that are owed by taxpayers. Beginning in FY 1987, we will add 2,500 positions for Examinations in each of three fiscal years, for a total of 7,500 positions. This initiative will produce an estimated $4.6 billion in additional revenue during Fiscal Years 1987-1989. This proposal is recommended by the President's

Private Sector Survey on Cost Control, and involves the collection of taxes that are legitimately owed. It is only equitable that we not ask the vast majority of American taxpayers, who pay their fair share of taxes, to have to subsidize those who do not contribute. To implement this initiative, we will conduct some advance hiring at the end of Fiscal Year 1986.

Our budget also provides, within existing resource levels, for implementation of certain provisions of the Deficit Reduction Act of 1984. Specifically, we will enforce the new tax shelter registration requirements, as well as provisions which will provide additional information to IRS. The tax shelter requirements are especially important as they will provide IRS with the ability to identify and target abusive shelters for enforcement action.

A sixth major objective of this budget is to accomplish productivity savings through improved management and automated systems. Specifically, our budget identifies savings of $23 million and 748 positions. The majority of these savings will result from efficiencies in the processing of tax returns and automation of the collection field function.

In addition to the major objectives that we have identified, our budget anticipates a large and growing workload. Some examples include:

-- IRS will process 178.7 million tax returns, an increase of 3% above the previous year.

-- We expect to audit or contact over 2.7 million taxpayers, close an estimated 3.3 million delinquent tax accounts, and provide some form of assistance to over 55 million taxpayers.

-- We anticipate that 311 million passengers will arrive at U.S. borders; this represents a growth of 4.3%. We will process 7.1 million formal entries of merchandise -- 6% more than in FY 1985.

-- Treasury will issue over 80 million savings-type securities and redeem more than 82 million. We will make over 731 million payments, an increase of 2% above the prior year.

-- We will print 6.6 billion pieces of currency, an increase of 6.5%, and 35.8 billion postage stamps, an increase of 3%. We will manufacture approximately 16.2 billion coins.

In summary, in terms of the major overall changes to the budget, we are seeking:

-- $67.1 million for program enhancements, related primarily to the objectives that I have described;

-- $14.6 million for increased workload, especially in the area of tax administration;

-- $262.4 million for price increases in such areas as communications, office space, travel, and utilities; and

-- an offset of $387.3 million in program reductions. These include the 5% pay cut, the 10% savings in administrative areas, and various productivity and one-time savings throughout the Department.

FISCAL YEAR 1985 PROPOSALS

Our budget contains supplementals totalling $77.1 million and rescissions totalling $9.5 million for Fiscal Year 1985. The supplemental requests include $44.9 million to cover 50% of the pay increase effective this past January and program supplementals of $32.2 million.

The program supplementals include funds to cover the recent postage rate increase for the Financial Management Service; to establish the 13th Organized Crime Drug Enforcement Task Force in Miami; to make certain security improvements to the White House, Naval Observatory, and Main Treasury; to provide a one-time capitalization increase to the IRS' Tax Lien Revolving Fund; to support the Customs Seizure Fund; and to establish User Fees at Certain Small Airports.

The proposed rescissions of $9.5 million are in response to Section 2901 of the Deficit Reduction Act of 1985. That Section requires executive branch agencies to achieve savings in costs associated with motor vehicles, travel, consulting services, printing, and public affairs.

Mr. Chairman, that summarizes the major proposals of the Treasury Department. I shall be happy to answer any questions that the Subcommittee may have.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Statement of the Honorable
Dr. David C. Mulford
Assistant Secretary for International Affairs
Department of the Treasury
before the
Foreign Operations Subcommittee
of the
House Appropriations Committee
on
Wednesday, April 3, 1985

Thank you, Mr. Chairman for this opportunity to share with you and your committee members my thoughts on the economic situation in Israel. All of us share a strong interest in and commitment to the stability and vibrancy of Israel's economy. President Reagan told visiting Prime Minister Peres last October 9 that the Administration would work closely with his government to avert balance of payments problems. It is in this spirit of cooperation that the Administration has been holding talks with Israeli officials over the past six months on their plans to lay the foundation for a sustainable economic recovery. These talks have been frank and constructive and are continuing.

Over the past decade or so Israel's economy has lost the vitality it so clearly demonstrated in the 1950s and 1960s. Israel, like most nations, had to face the many sharp changes in the international economic environment of the 1970s, such as higher oil prices, deeper than usual trade slumps, and generally higher annual rates of inflation. In the case of Israel, these changes were complicated by unique circumstances such as the 1973 War and the loss of the oil fields in the Sinai. The economic adjustment required of Israel by these events was substantial. In recognition of this special hardship and to ease the pain of adjustment, U.S. economic and military assistance was increased and the terms were eased.

Nonetheless, Israel has not fully adjusted to the new external environment. As a result, its economy has reached an unsustainable position with high rates of inflation, large balance of payments deficits and anemic growth rates.

What we see today is an economy gripped by an increasingly inflexible system that has stifled its economic dynamism. The Government's role in the economy and the size of its work force

have expanded to the point where the budget deficit is no longer supportable by existing resources. The ratio of central government expenditure to GDP has been increasing along with the budget deficit. In addition, real wage increases in both the public and private sectors in recent years have exceeded productivity increases. Total demand for goods and services has thus been outstripping supply and resulting in ever increasing price rises, growing external imbalances and more recently declining foreign exchange reserves.

The government's attempts to stabilize the economy generally have been through administrative measures. For example, it has tried to hold down prices and promote exports through subsidies. However, the beneficial impact on prices and exports has been temporary. These measures, on the other hand, have added to government expenditures and increased the need for higher taxes. Israel already has one of the highest marginal tax rates in the world, so many Israeli citizens go to great lengths to avoid paying taxes.

Meanwhile, the Central Bank's role in financing the budget deficit has been increasing. Until recently the government was able to finance a major portion of its deficit by selling debt instruments. At present, however, Israeli citizens are less willing to hold government debt instruments because of high inflation and economic uncertainty. As a result, to finance the deficit the Central Bank has been expanding the money base, which brought inflation to over 1000% just prior to the wage/price controls which were launched last November. While the wage/price agreements have reduced the monthly rate of price rises, inflationary pressures remain very strong under the surface.

Israel's inflationary environment, previous stop-go policies and very high marginal tax rates have hurt the investment climate. As a result, the investment/GDP ratio has dropped from above 30 in the 1960's to around 20 in recent years. Investment in plant and equipment, which is so essential for future growth and employment, has suffered an even greater decline. More recently, there also has been a loss in foreign investors' confidence. Partly as a reflection of this diminished confidence, Israel's official reserves have been decreasing since last June.

If Israel is to regain the confidence of domestic and foreign investors, its authorities must restore market incentives to their appropriate role in the economy. We are encouraged by Prime Minister Peres' determination to correct the country's difficult economic problems and desire to give market forces greater play. Since last November he has taken a number of measures intended to address those problems. While I would not necessarily agree with his administrative approach, I believe that he has taken some very positive steps. However, judging by the results to date, more needs to be done. The Israeli authorities recognize this fact and are working on further measures.

A sharp reduction in government expenditures is key to Israel's economic adjustment efforts. Last week the Knesset approved the FY 85/86 budget which reflects a major cutback from the expected level of expenditures for the fiscal year that ended on Sunday, March 31. In the past, however, Knesset approved budgets were routinely increased during the course of the year. We hope that the recently passed legislation to improve expenditure discipline will minimize this kind of deviation in the future.

To be truly effective in the Israeli environment, fiscal restraint must be complemented by appropriate monetary policy. The Israeli authorities need to find a way to reduce the amount of money creation connected with the financing of the budget deficit. In this regard, we believe that the authorities need to devise a plan that would enable the government to finance its deficits in a non-inflationary manner.

We expect to continue our dialogue with Finance Minister Modai and his collegues as they develop additional measures that will lay the foundation for a return to non-inflationary growth. In these discussions, we will be reaffirming President Reagan's commitment to provide financial support and we will be exploring ways in which this support can be of maximum benefit to the Israeli economy.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON April 4, 1985

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $8,300 million of 364-day Treasury bills to be dated April 18, 1985, and to mature April 17, 1986 (CUSIP No. 912794 KB 9). This issue will not provide new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $8,282 million.

The bills will be issued for cash and in exchange for Treasury bills maturing April 18, 1985. In addition to the maturing 52-week bills, there are $13,696 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks as agents for foreign and international monetary authorities currently hold $2,138 million, and Federal Reserve Banks for their own account hold $3,811 million of the maturing bills. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for themselves and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $275 million of the original 52-week issue.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Standard time, Thursday, April 11, 1985. Form PD 4632-1 should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves

the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on April 18, 1985, in cash or other immediately-available funds or in Treasury bills maturing April 18, 1985. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

April 8, 1985

J. Roger Mentz Appointed
Deputy Assistant Secretary of the Treasury for Tax Policy

Secretary of the Treasury James A. Baker, III, today announced the appointment of J. Roger Mentz, a partner in the New York City law firm of Mudge Rose Guthrie Alexander & Ferdon, as Deputy Assistant Secretary of the Treasury for Tax Policy, effective April 15, 1985.

Mr. Mentz, 43, will serve as Deputy to Assistant Secretary Ronald A. Pearlman, who has principal responsibility for formulation and execution of United States domestic and international tax policies.

Mr. Mentz earned a B.S.E. degree with honors in chemical engineering from Princeton University in 1963. He received his L.L.B. degree from the University of Virginia Law School in 1966, where he served on the editorial board of the Virginia Law Review and was a member of the Order of the Coif. Mr. Mentz has practiced law with Mudge Rose since his graduation from law school.

Mr. Mentz has served on the Executive Committee of the New York State Bar Association Tax Section since 1973 and served as Chairman of the Tax Section from 1982-83. He is also a member of the American Bar Association Section of Taxation. Mr. Mentz was an Adjunct Associate Professor at the New York University Law School L.L.M. Program from 1979-80, where he taught a course in international taxation. He has also written extensively on a variety of tax issues.

Mr. Mentz and his wife Marilyn have two children, Steven and Tanna.

# # #

B-77

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE April 8, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,673 million of 13-week bills and for $6,666 million of 26-week bills, both to be issued on April 11, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 11, 1985			26-week bills maturing October 10, 1985		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	8.13%	8.42%	97.945	8.54%	9.05%	95.683
High	8.14%	8.43%	97.942	8.57%	9.08%	95.667
Average	8.14%	8.43%	97.942	8.56%	9.07%	95.672

Tenders at the high discount rate for the 13-week bills were allotted 80%.
Tenders at the high discount rate for the 26-week bills were allotted 76%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 399,950	$ 44,500	$ 395,435	$ 45,435
New York	17,439,850	4,415,105	14,245,565	5,356,885
Philadelphia	25,550	23,550	23,030	23,030
Cleveland	68,555	43,555	50,105	50,105
Richmond	41,160	41,160	50,870	50,630
Atlanta	45,830	44,830	40,835	39,835
Chicago	1,167,265	101,090	1,518,505	356,545
St. Louis	73,285	53,285	59,430	44,550
Minneapolis	38,370	33,370	33,655	33,655
Kansas City	65,730	62,730	78,265	75,785
Dallas	41,680	31,680	39,115	32,915
San Francisco	3,635,050	1,387,050	1,605,075	79,195
Treasury	390,800	390,800	477,330	477,330
TOTALS	$23,433,075	$6,672,705	$18,617,215	$6,665,895
Type				
Competitive	$20,880,330	$4,119,960	$15,792,065	$3,840,745
Noncompetitive	1,283,955	1,283,955	1,183,405	1,183,405
Subtotal, Public	$22,164,285	$5,403,915	$16,975,470	$5,024,150
Federal Reserve	1,201,835	1,201,835	1,100,000	1,100,000
Foreign Official Institutions	66,955	66,955	541,745	541,745
TOTALS	$23,433,075	$6,672,705	$18,617,215	$6,665,895

An additional $8,345 thousand of 13-week bills and an additional $47,255 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-78

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. April 9, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,700 million, to be issued April 18, 1985. This offering will not provide new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,696 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Standard time, Monday, April 15, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,850 million, representing an additional amount of bills dated January 17, 1985, and to mature July 18, 1985 (CUSIP No. 912794 HS 6), currently outstanding in the amount of $7,026 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,850 million, to be dated April 18, 1985 and to mature October 17, 1985 (CUSIP No. 912794 JC 9).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing April 18, 1985. In addition to the maturing 13-week and 26-week bills, there are $8,282 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,833 million of the original 13-week and 26-week issues. $2,108 million is currently held by Federal Reserve Banks as agents for foreign and international monetary authorities, and $3,914 million is held by Federal Reserve Banks for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE April 11, 1985

TREASURY OFFERS $4,000 MILLION OF 3-DAY
CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $4,000 million of 3-day Treasury bills to be issued April 15, 1985, representing an additional amount of bills dated April 19, 1984, maturing April 18, 1985 (CUSIP No. 912794 GK 4).

Competitive tenders will be received only at the Federal Reserve Bank of New York up to 1:00 p.m. Eastern Standard time, Friday, April 12, 1985. Wire and telephone tenders may be received at the discretion of the Federal Reserve Bank of New York. Each tender for the issue must be for a minimum amount of $10,000,000. Tenders over $10,000,000 must be in multiples of $1,000,000. Tenders must show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions must not be used.

Noncompetitive tenders from the public will not be accepted. Tenders will not be received at the Department of the Treasury, Washington, or at any Federal Reserve Bank or Branch other than the Federal Reserve Bank of New York.

The bills will be issued on a discount basis under competitive bidding, and at maturity their par amount will be payable without interest. The bills will be issued entirely in book-entry form in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches. Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m., Eastern time, on the day of the auction. Such positions would include bills acquired through "when issued" trading, futures,

and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e. g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Those submitting tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank of New York in cash or other immediately-available funds on Monday, April 15, 1985. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars may be obtained from any Federal Reserve Bank or Branch.

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 11, 1985

CONTACT: CHARLES POWERS
(202) 566-2041

UNITED STATES AND SRI LANKA SIGN NEW INCOME TAX TREATY

The Treasury Department today announced that a new income tax treaty was signed with Sri Lanka in Colombo on March 14, 1985. The proposed treaty will be sent to the Senate for its advice and consent to ratification.

The treaty covers the U.S. Federal income tax and certain Federal excise taxes, and the Sri Lanka income tax, including the income tax based on the turnover of enterprises licensed by the Greater Colombo Economic Commission. The proposed treaty provides for maximum rates of tax at source of 15 percent on dividends. Interest and royalties will be subject, in general, to a maximum tax at source of 10 percent. Interest, however, will be exempt at source if paid by the Government of the United States or Sri Lanka or by a political subdivision or local authority of one of the Governments, or if received by one of the Governments or a Government agency. Rental payments for the use of tangible personal property are subject to a maximum tax at source of 5 percent.

The treaty contains provisions dealing with the taxation of business profits, personal service income, capital gains and other types of income, as well as provisions relating to the administration of the treaty and the taxes to which it applies. The treaty provides for the exchange of information relating to income and certain other taxes.

The treaty contains provisions, similar to those found in other U.S. tax treaties, designed to prevent abuse of the treaty by limiting its benefits to persons properly entitled to those benefits.

The proposed treaty contains an article relating to grants which may be made by the Government of Sri Lanka for purposes of economic development. The article simply confirms current U.S.

law by providing that in appropriate circumstances such grants will be treated for U.S. tax purposes as contributions to capital and not as income.

The treaty is subject to ratification. It will enter into force upon the exchange of instruments of ratification. The provisions of the treaty will have effect in respect of taxes withheld at source on the first day of the second month following entry into force; in respect of other taxes, it will have effect for taxable periods beginning on or after the first day of January of the year in which the treaty enters into force.

A limited number of copies of the treaty are available from the Public Affairs Office, Treasury Department, Main Treasury Building, Room 2315, Washington, D.C. 20220, telephone (202) 566-2041.

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TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

April 11, 1985

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $ 8,337 million of 52-week bills to be issued April 18, 1985, and to mature April 17, 1986, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	8.43%	9.14%	91.476
High -	8.44%	9.15%	91.466
Average -	8.44%	9.15%	91.466

Tenders at the high discount rate were allotted 56%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 378,680	$ 28,680
New York	21,224,795	7,574,570
Philadelphia	17,105	17,105
Cleveland	25,955	25,955
Richmond	61,645	30,645
Atlanta	26,315	26,295
Chicago	1,145,525	106,585
St. Louis	80,270	60,270
Minneapolis	19,430	19,430
Kansas City	51,660	47,960
Dallas	8,560	8,560
San Francisco	2,020,325	227,325
Treasury	163,440	163,440
TOTALS	$25,223,705	$8,336,820
Type		
Competitive	$22,957,830	$6,070,945
Noncompetitive	740,875	740,875
Subtotal, Public	$23,698,705	$6,811,820
Federal Reserve	1,400,000	1,400,000
Foreign Official Institutions	125,000	125,000
TOTALS	$25,223,705	$8,336,820

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TREASURY NEWS

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FOR IMMEDIATE RELEASE April 12, 1985

RESULTS OF TREASURY'S AUCTION OF 3-DAY CASH MANAGEMENT BILLS

The Treasury has accepted $4,001 million of the $28,858 million of tenders received at the Federal Reserve Bank of New York for the 3-day Treasury bills to be issued April 15, 1985, and to mature April 18, 1985, auctioned today. The range of accepted bids was as follows:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	8.39%	8.52%	99.930
High	8.46%	8.52%	99.930
Average	8.43%	8.52%	99.930

Tenders at the high discount rate were allotted 30%.

TREASURY NEWS

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Statement of the Honorable
James A. Baker, III
of the United States of America
Concerning the Problem
of Mixed or Tied Aid Credits
Before the Meeting of the
OECD Council at Ministerial Level
April 11, 1985
Paris, France

Over the course of the last four years, the OECD export credits group has made remarkable progress in eliminating export credit subsidies. Unfortunately, the proliferation of tied aid credits designed for commercial advantage threatens to undermine this progress.

The United States deeply regrets that the trade and development assistance committees were unable to fulfill the 1984 ministerial mandate to take "prompt action" to improve both discipline and transparency over tied aid credits. While the export credits group has made progress improving transparency, and the Development Assistance Committee has made technical improvements in both transparency and discipline, neither committee has moved in any meaningful way to install the discipline necessary to eliminate the trade- and aid-distorting effects of using low grant element tied aid credits. As a result, the use of tied aid or mixed credits to promote exports and penetrate markets at the expense of real development continues unabated and -- even more disturbingly -- may be expanding.

The United States has proposed several ways to improve discipline and thus elimate the commercial abuse of tied aid credits. The clearest, simplest, and most direct solution is the U.S. proposal to ban tied aid credits with a grant element below 50 percent.

By significantly raising the grant element, this approach helps ensure that tied aid credits are used for sound development purpose by raising the cost of using them for export promotion. It is an objective test. It can be administered and enforced. It reduces the temptation, whatever a country's official aid policy or motivation, to misuse its foreign aid for commercial ends. The average grant element for all official development assistant (ODA) loans was 56-58 percent compared to 25 percent for tied or mixed aid credits.

Let us keep the distinction between development assistance and commercial credits that is so important not only to industrialized countries but to the developing countries as well. The United States recommends again that all OECD ministers agree to improve discipline by substantially increasing the minimum permissible grant element and commensurately raising the grant element in the definition of official development assistance.

If that cannot be achieved immediately, I would propose the following package as an interim solution:

- A commitment for OECD ministers to improve discipline and elimate the commercial use of tied aid credits.

- As a first step, a significant increase in the minimum permissible grant element.

- General acceptance of the European Community's transparency proposal on definition, prior notification, and prior consultation, with the details to be worked out by the appropriate OECD committees.

- New instructions to appropriate OECD committees to develop, and to implement by a date certain, specific measures to improve discipline further. (At a minimum, a study of alternatives should be completed by September 30, 1985, and the specific measures should be fully in force by the next OECD ministerial.)

- If progress on an adequate alternative for further improving discipline is not possible and fully in force by the next ministerial review, a ministerial committee that a further increase in the permissible grant element will automatically come into force.

We have an opportunity at this ministerial to move to eliminate this unfair practice and resolve this increasingly troublesome issue. I urge, therefore, that we set a substantial increase in the grant element as our goal. I think we can and should move to that goal now. If we are unable to agree to increasing the discipline in one step, then I urge we adopt this compromise package as an interim approach to resolving the vexing problem of tied aid credits.

The U.S. has been exercising restraint in the use of mixed credits because we view the practice as unfair. If, however, the continued refusal of a few to agree continues to prevent progress on an issue that most view as particularly troublesome, the U.S. will have no alternative but to follow the advice of many in our country who suggest to us that we "fight fire with fire" and ourselves make wide use of this device.

This we would like to avoid.

TREASURY NEWS

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Statement by the Honorable James A. Baker III
Secretary of the Treasury
of the United States of America
Concerning
Progress In Implementing the Debt Strategy
Before The
Meeting of the OECD Council
at Ministerial Level
April 11, 1985
Paris, France

Mr. Chairman, Secretary General Paye, distinguished colleagues. It seems appropriate that the first international meeting I attend as Secretary of the Treasury should be at the OECD. In its early days, as the Organization for European Economic Cooperation, and in its present, broader configuration, this organization has exemplified international cooperation. The progress made over the years in improving the living standards of our nations in indicative of the value of our working together. I look forward to being a part of the long, productive relationship the U.S. has had with the OECD and to building close, working ties with my colleagues in this room.

The Debt Strategy

International debt problems in the developing countries emerged clearly, as we all know, about two and a half years ago. Initially, there were calls for generalized solutions to the financing needs of the debtor countries. Many of these proposals entailed quite dramatic departures from traditional practices and would have involved generalized debt relief for all debtors, regardless of their particular need or circumstances. Fortunately, these proposals did not find widespread favor in either developed or developing countries -- for, had they been adopted, they would have proved counter-productive. More appropriately, a five-point strategy was devised, based on a case-by-case approach to debt problems.

This case-by-case approach, still in force, involves the following key elements:

1) Adjustment by debtor countries to restore balance of payments equilibrium and growth;

2) Sustained noninflationary growth and open markets in industrial countries to provide export opportunities for LDCS;

3) Provision of adequate resources for the international financial institutions, with a central role for the IMF;

4) Continued commercial bank lending to countries making determined adjustment efforts;

5) Selective bridge financing by the financial authorities of industrial countries.

This strategy has envolved over time and been strengthened as needed. For example, at last year's London Summit it was recognized that year-by-year rescheduling might not be necessary or appropriate for all debtors. Banks and governments were encouraged to consider multi-year rescheduling agreements for certain countries which have undertaken successful, sustainable efforts to improve their performance and external payments position.

Progress in Implementation

Reviewing actual performance over the past year in light of these debt strategy elements suggests that clear progress has been achieved. Developments to date have been consistent with the eventual resolution of the problem. Let's look at where we stand.

Last year we saw a strong acceleration of LDC real growth. We estimate LDC real GNP rose almost 4.5 percent in 1984, and expect a continuation near this rate in 1985 and 1986. This average does, however, conceal a wide range of variation in performance among LDCS. The best performance has been in some of the dynamic Asian countries, most of which avoided serious debt problems by adjusting within a few years to the 1979-80 oil price shock. For 1985 and 1986, we expect real growth in the 6-8 percent range in the Asian region.

Practically all major debtors have adjustment programs, most with the support of the IMF, and have taken steps to improve their balance of payments positions. As a group, non-OPEC LDCS reduced their current account deficit by $54 billion between 1981 and 1984. Initially, the improvement was due largely to reduced imports. But in 1984, the reduction in the deficit reflected a 12 percent increase in exports to industrial nations; to the United States alone they rose 21 percent. In fact, the U.S. accounted for over 50 percent of the improvement in the trade balance of the non-OPEC LDCS in the first three quarters of 1984.

These last figures suggest that the industrial nations have also worked hard at fulfilling their role in the strategy. Improved average real growth in OECD economies -- 3.5 percent in 1984 excluding the U.S. -- and particularly strong U.S. growth -- 6.8 percent in 1984 -- has expanded markets for LDC exports considerably. We will focus more heavily on the OECD economic situation tomorrow, but it is clear that by providing increased export opportunities for the LDCS, some OECD countries have played an important role in their adjustment efforts.

The IMF has played a central and constructive role in implementing the debt strategy. The quota increase, the expansion and modification of the GAB, and other borrowing arrangements have provided the IMF with sufficient resources to meet foreseeable needs for temporary balance of payments financing over the next few years. The IMF'S effectiveness in promoting economic adjustment has helped catalyze countries.

Two years ago skeptics questioned whether the case-by-case approach would provide adequate financial assistance. In practice, this approach generally has resulted in sufficient levels of financial flows. Private banks have reduced their net new lending from earlier unsustainably high rates but have remained a significant factor in support of the adjustment process, providing some $18 billion to non-oil developing countries in 1983. And from the beginning of 1983 through 1984, agreements have been concluded, or reached in principle, for rescheduling of debt to commercial banks for 30 countries amounting to about $144 billion.

While we have made some progress, much remains to be done to restore fully the conditions for sustainable growth. Developed and developing countries, commercial banks and the international financial institutions must all continue to share the responsibility for ensuring a successful outcome.

There is a clear willingness among many debtor governments to take the measures needed to restore balance to their economies. But in some cases, there have been problems in keeping countries moving in the right direction. Some of the major debtors have only recently adopted, or still need to implement, effective adjustment measures. Others have seen marked improvement in external positions, but the sustainability of this improvement depends heavily on the successful reduction of internal imbalances, and the creation of an environment more conducive to growth. In many cases, both domestic and external adjustment efforts should be reinforced, including the adoption of more realistic exchange rates, improving the functioning of domestic markets, reducing fiscal imbalances, and liberalizing trade and investment regimes. There is a pressing need to reduce inflation, both through the standard macroeconomic policy tools and through complementary measures such as wage policy and financial reform. These are often politically difficult measures, yet they are crucial for the restoration of sustainable growth and creditworthiness.

OECD growth is likely to be slower this year, as the U.S. moves to a somewhat lower but more sustainable growth rate. Many observers feel that average OECD growth of 3-1/2 percent is required to expand LDC export markets. I think OECD growth of 3-1/2 percent is sustainable and hopefully the minimum we will experience over the medium term if all OECD countries take necessary action to implement domestic policies that address our respective barriers to stronger economic performance. We can thus provide open, growing markets in support of developing countries' adjustment efforts. It is particularly important that Europe and Japan do this as the U.S. economic expansion moderates in 1985.

Recently, net new lending to less developed debtors by commercial banks has slowed. To some degree this was expected. It reflects in part lower current account deficits in the countries concerned as well as prudential concerns. Most of this new lending is occurring only under commitments which are part of IMF supported packages of policy reform and debt restructuring. There is, perhaps, a natural tendency to look only at past problems rather than at present adjustment efforts and the future beneficial impact of policy changes that have occurred both in developing and developed countries. Decisions to lend should be considered not only in the context of traditional calculation of expected profits compared to expected risks, but against the risk of not taking action to help solve the current debt problem. I believe that a moderate but regular increment of new credit for countries that are adjusting their economies is essential for the resumption of growth and creditworthiness. Bankers must see themselves as an important part of the equation to resolve the debt problem over the medium term.

Some have looked to the debt strategy for a quick-fix or simple solution. But the debt situation is the accumulation of years of problems and will not be improved overnight. I think it is useful to view the strategy as a road map. It shows us the unique route to our destination -- sustainable growth and the restoration of creditworthiness in troubled debtor nations. We have already traveled many miles down the road and successfully hurdled some obstacles in our path. Yet some distance remains, and it will take time to arrive at the end of our journey. While the general situation continues to improve, we will be faced with country problems of varying degrees of seriousness from time to time. Unrelenting efforts by developed and developing countries, commercial banks and the international financial institutions to fulfill the responsibility outlined in the debt strategy will, I think, help ensure that we arrive safely at our destination.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

(Corrected Copy)

STATEMENT BY
JAMES W. CONROW
DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT INSTITUTIONS
AND FINANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
APRIL 16, 1985

Mr. Chairman, it is a pleasure to appear before the Committee to present the Administration's legislative proposals for the multilateral development banks, or "MDBs. In negotiating these proposals, the Treasury Department made every effort to keep the Committee informed and to take its views into account. We trust that the results of our negotiations will have your support.

African Development Fund

The first program which I would like to address today is the replenishment of the African Development Fund, or "AFDF". This particular institution is designed to help advance our humanitarian objectives. In recent months, we have all been struck by the plight of hungry people in Africa and by the bleak economic prospects for the region.

However, it is generally acknowledged that the long-term food problem can only be solved by putting Africa in a position where it can produce more food for itself, and this cannot be done without development assistance.

B-86

The African Development Fund replenishment is in large part targeted to precisely that purpose. The proposal is to participate in the $1.5 billion Fourth Replenishment of the African Development Fund with a U.S. contribution of $225 million dollars over three years. The United States would be the largest single donor, providing 15.4 percent of the total -- followed by Japan with 14 percent and Canada with 9.5 percent.

In the negotiations, we succeeded in obtaining a commitment that ninety percent of replenishment resources would be allocated to countries with per capita GNPs of less than $510 per year. The remainder is to go to countries with per capita GNPs of less than $990. This will help meet the developmental needs of the poorest African countries, whose per capita incomes are low and whose capacity to repay external debt is limited.

During the replenishment, 40 percent of the lending will be given to projects aimed at meeting basic food requirements (including food production, processing, storage, marketing, and distribution). Human resource development and maintenance through educacation and health projects will also be emphasized and are slated to receive 15 percent of AFDF lending. The Fund will lend 10 percent of its resources for basic infrastructure (water supply and sewage, telecommunications, and electricity) which provide services to the urban or rural poor. Twenty-five percent of Fund lending will go for transportation projects which would provide market outlets for agricultural produce or private trade or would better integrate transport systems to improve the delivery of food or other priority commodities. We succeeded in limiting the level of non-project lending to five percent of the total replenishment.

The United States has a strong humanitarian interest in aiding Sub-Saharan Africa, as well as important political and security interests.

Economic development has been particularly slow in Africa over the past decade. Part of this poor performance can be attributed to inappropriate economic policies. In addition, Sub-Saharan Africa has had to cope with an extensive drought, adverse external economic conditions, such as world-wide recession and falling commodity prices, and civil conflict. Recently there has been a growing awareness among African countries of the need to reassess their development strategies to make better use of available resources. While Africa continues to face a difficult development challenge, more African governments now agree that properly valued exchange rates, incentive prices for farmers, and a better allocation in investment resources are important preconditions to economic growth. Whether this new realism will result in more effective economic policies and better results depends on how quickly African Governments act and how much support the international community will provide.

The economic crisis in Africa is especially evident in agriculture. Few countries have seen their agricultural output increase by as much as 3 percent a year during the 1970s and early 1980s. In a number of countries, agricultural production has either stagnated or actually fallen during this period. At the same time, population has been increasing by an annual average of 2.5 percent in the 1960s, 2.7 percent in the 1970s and about 3 percent in more recent years. Per capita food production is currently less than 80 percent of the level which prevailed during the period of 1961-65. Not surprisingly the result has been an increasing dependence on imported food for consumption -- using scarce foreign exchange resources that are then unavailable for investment.

The problems facing African countries reinforce the need for major adjustment in economic policies, especially the removal of the economic policy bias against agricultural production. In instances where countries have undertaken appropriate economic adjustment measures, there has been an encouraging increase in the production of agriculture. While more countries are determined to alter policies to improve the outlook for economic revival, concessional assistance is an essential complement in support of their efforts.

The African Development Fund, with its emphasis on lending for agriculture, water supply, health and transportation can be an effective channel for responding to the key development problems of Africa.

The nations of Africa view the African Development Bank and Fund as their regional development institutions. While other development agencies may supply more funds, the African Development Bank and Fund are particularly important as regional forums for discussing continent-wide financial and economic issues. The level of U.S. participation in the Bank and Fund is viewed by many in Africa as a gauge of U.S support for the development objectives of African countries.

I hope the Committee will support the Administration's proposal for the African Development Fund.

International Finance Corporation

A fundamental component of the Administration's approach to development assistance is the conviction that the private sector holds the key to economic growth in developing countries. Treasury's 1982 assessment found that those nations that have encouraged private sector development, both domestic and from abroad, have generally achieved more rapid and sustainable growth than those which

have not. Put simply, market-oriented private enterprise -- by responding to profitable opportunities -- produces jobs, earns foreign exchange and builds a technical and managerial base in the labor force.

The proposal to participate in the capital increase for IFC is our third -- and most important -- step toward strengthening MDB support for the private sector in developing countries. In many respects, Treasury's 1982 assessment found that direct support from the MDBs for the private sector had lagged in recent years. Since taking office, the Administration has joined with other member countries to support:

-- the start-up of a small but well-targetted equity investment program in the Asian Development Bank.

-- the creation of the Inter-American Investment Corporation, and

-- now, a significant redirection and capitalization of IFC.

The Administration's proposal is for a $175 million U.S. share in a five year $650 million dollar IFC capital increase, that would double IFC's authorized capital to $1.3 billion.

Specifically, the Administration's legislative proposal would authorize the U.S. Governor to vote in favor of the proposed capital increase, to subscribe subject to appropriations to IFC shares valued at $175 million and to authorize the appropriation of $175 million to pay for these shares.

The previous capital increase for IFC was approved in 1977. The final U.S. subscriptions were provided by the Congress in 1981. The 27 percent U.S. share of IFC capital is being maintained in the proposed replenishment.

IFC has made valuable contributions to the economies of developing countries through a broad spectrum of industries, including agrobusiness, building materials, chemicals, wood products, tourism, energy and financial services. Since its establishment in 1956, IFC has invested $5.2 billion in 83 countries.

IFC is also doing pioneering work to improve the environment for direct foreign investment and to increase the flow of international equity capital. IFC has provided technical assistance to help developing country governments write legislation to attract foreign direct investment. It has supported the formation of several new equity investment funds designed to foster more rapid development of emerging capital markets in some of the developing countries. We commend this initiative and are encouraging IFC to expand its efforts in this area.

The proposed capital increase is designed to mobilize foreign and domestic sources of capital at a commendable ratio of six to one to be used in support of a five year investment program totalling $4.4 billion. The program feature major investment initiatives in the following areas:

-- For an Expanded Capital Market Development Program: IFC is the principal -- and in many countries, the only -- multilateral development institution providing technical assistance to develop new financial instruments and to establish stock markets. In addition, IFC is the main multilateral development institution funding private financial firms. The five year program would earmark 14 percent, or roughly $500 million, for financial market and institutional development.

-- For Corporate Restructuring: The economic adjustment process which many developing countries are going through has placed severe constraints on the growth of the private sector and the availability of credit. To help private firms adapt to these constraints and become leaner, more efficient economic endeavors, IFC anticipates providing technical assistance and investing about $210 million to support firms that can restructure their businesses into more promising areas. Financial resources will be provided for working capital loans, for long-term capital or for equity, as circumstances may suggest.

-- For Energy Exploration and Development: IFC contemplates investing about $100 million in exploration activities with the participation of small independent oil service or production companies, which have thus far invested in developing countries only to a limited extent. The IFC share of such ventures would normally be limited to ten percent in order to maximize the catalytic role of the Corporation. In addition, up to $400 million more would be invested in other energy ventures, including energy development and production, through loans or equity.

-- For Sub-Saharan Africa: Tradeoffs between sound and creditworthy investment and sometimes risky developmental objectives are necessary in Sub-Saharan AFrica where the national economic policies and the availability of entrepreneurial talent are least favorable. To enhance the chances for successful private sector development, IFC has fashioned a $478 million, four-pronged strategy for Sub-Saharan Africa:

* More intensive promotional activities. IFC will offer investment analysis and advisory services through expanded venture capital companies. These services will earn appropriate fees whenever possible.

* Taking a larger investment share. In circumstances where it proves difficult to mobilize resources for otherwise worthwhile projects in Africa the IFC may waive its usual practice of limiting participation to 25 percent of total capital.

* More and smaller projects. In full knowledge that project preparation costs per unit of investment will be higher, IFC will invest in projects in the $1 million to $5 million range to take advantage of the relatively larger number of opportunities for smaller scale investments in the region.

* More intensive use of development finance corporations. To reach the many investment opportunities below the $1 million level in Africa IFC will make more intensive use of well-run development finance corporations, even if government owned.

The Administration believes that the proposal to increase IFC capital -- together with companion activities in the other MDBs -- will give a strong impetus to a private sector development effort that holds real potential for long term growth.

The IBRD Selective Capital Increase

The IBRD -- an estimated $11 billion lending program in fiscal year 1985 -- is the world's preeminent multilateral financial intermediary operating in developing countries.

The Administration strongly supports the IBRD and is committed to working constructively with management and other members to increase the Bank's effectiveness. In addition to its proven expertise as an investment project lender, we value highly the Bank's ability to provide essential policy guidance and technical assistance, and to act as a catalyst in encouraging private enterprise and investment capital. The importance of the IBRD to recipient countries is underscored by the very difficult adjustment problems now faced by many developing countries and by the Bank's very considerable efforts to encourage and facilitate such adjustment.

The United States has regarded "equitable cost-sharing" among donors to be a key element of our participation in the MDBs and has over time gradually reduced the U.S. share in all the MDBs, including the World Bank. To this end, the United States has traditionally been a strong supporter of "parallelism" insofar as it suggests that countries which, by virtue of their economic growth, have taken a larger quota in the International Monetary Fund (IMF),

should take up increased shares in the capital stock of the IBRD. This is accomplished by Selective Capital Increases, with the United States and other Bank members supporting the practice of timing such SCIs to follow closely IMF quota reviews.

In April, 1983, World Bank management proposed initiating consultations with Bank members regarding an SCI to "parallel" the increase in IMF quotas, which had been adopted. The Bank's position was that an increase of 141,800 shares -- amounting to about $17 billion -- would be necessary to parallel fully the IMF's quota increases.

The U.S. position in subsequent SCI negotiations had three key elements:

(a) to focus an SCI specifically on the need to adjust shares and not as a means of supporting increased Bank lending,

(b) to get the cost of the SCI to the United States as low as possible, and

(c) to provide the United States with the option of subscribing a level of shares sufficient to retain a U.S. veto (i.e., 20 percent of the voting power) over any amendment of the Bank's Charter.

After more than a year of negotiations, the Bank's Executive Directors agreed on an SCI in May 1984 which would increase the IBRD's capital stock by 70,000 shares valued at $8.4 billion, of which 8.75 percent would consist of paid-in capital. The proposed allocation for the United States was 12,453 shares or 17.8 percent of the total, valued at $1.5 billion. Following the SCI, the United States would still retain a 20 percent share of IBRD allocated shares -- and thus, our veto over amendments to the Charter.

The most significant adjustment in country shares related to Japan. As a result of the SCI, Japan's ranking in the share capital of the IBRD -- i.e., potential voting power -- changed from fifth to second position. This change, while logical in terms of Japan's relative economic position in the world eocnomy, required a prolonged period of difficult negotiations among the Japanese and the three affected European countries (Germany, Britain and France) for whom "ranking" was sensitive from both a political and economic standpoint.

Japan's position as the second largest IBRD shareholder is in keeping with the size and importance of the Japanese economy and the need for Japan to assume greater responsibilities in the international financial system, commensurate with its economic strength and political importance.

U.S. subscription to the shares allocated by the 1984 SCI would cost $1,502 million of which 8.75 percent or $131.4 million, would be paid-in. The Administration has requested authorization for the full subscription in FY 1986, with the necessary appropriations provided in two equal installments in FY 1986 and FY 1987.

U.S. support for the SCI was conditioned on the understanding that the IBRD's lending program will not exceed a conservatively defined sustainable level of lending (SLL). This is defined as the level of IBRD lending to countries which can be sustained indefinitely (in nominal terms) without any further increase in Bank capital under current lending policies. A conservatively defined SLL is important to insure we do not come under pressure to subscribe to a new General Capital Increase on the grounds that the Bank's lending volume would decline without a GCI.

The SCI proposal shares the cost of IBRD membership more equitably. As a measure of support for an effective institution, we urge the Committee's favorable action.

Conclusion

The proposed legislation for the African Development Fund, International Finance Corporation and the World Bank is the result of three extended negotiations carried on over the last two years. I know you are aware, Mr. Chairman, of the course of those discussions.

Appropriations to fund these programs are included in the President's FY 1986 budget request. Thus, timely enactment of this legislation is essential.

I hope the Committee will conclude that these proposals are positive contributions to the U.S foreign assistance program and that the legislation merits your support.

TREASURY NEWS
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FOR IMMEDIATE RELEASE April 15, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,863 million of 13-week bills and for $6,851 million of 26-week bills, both to be issued on April 18, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 18, 1985			:	26-week bills maturing October 17, 1985		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.00%a/	8.28%	97.978	:	8.23%	8.71%	95.839
High	8.05%	8.33%	97.965	:	8.27%	8.75%	95.819
Average	8.04%	8.32%	97.968	:	8.27%	8.75%	95.819

a/ Excepting 2 tenders totaling $690,000.

Tenders at the high discount rate for the 13-week bills were allotted 99%.
Tenders at the high discount rate for the 26-week bills were allotted 76%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 388,540	$ 38,540	:	$ 385,185	$ 35,185
New York	14,591,640	4,895,540	:	16,758,995	5,787,875
Philadelphia	27,225	27,225	:	23,205	23,205
Cleveland	60,985	60,985	:	36,870	36,870
Richmond	60,005	60,005	:	64,260	60,960
Atlanta	47,650	47,650	:	48,675	47,475
Chicago	1,080,280	324,080	:	1,069,090	207,950
St. Louis	82,505	47,455	:	64,695	28,495
Minneapolis	17,345	17,345	:	16,270	16,270
Kansas City	67,565	67,565	:	51,895	51,675
Dallas	43,015	38,015	:	33,595	23,595
San Francisco	1,614,395	842,385	:	1,513,720	104,720
Treasury	396,065	396,065	:	426,520	426,520
TOTALS	$18,477,215	$6,862,855	:	$20,492,975	$6,850,795
Type					
Competitive	$15,607,990	$3,993,630	:	$17,190,150	$3,547,970
Noncompetitive	1,308,195	1,308,195	:	1,127,925	1,127,925
Subtotal, Public	$16,916,185	$5,301,825	:	$18,318,075	$4,675,895
Federal Reserve	1,304,630	1,304,630	:	1,250,000	1,250,000
Foreign Official Institutions	256,400	256,400	:	924,900	924,900
TOTALS	$18,477,215	$6,862,855	:	$20,492,975	$6,850,795

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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"HISTORIC" TAX REFORM: THE POPULIST CORRECTION

REMARKS BY
RICHARD G. DARMAN
DEPUTY SECRETARY OF THE TREASURY

BEFORE THE
INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION
WASHINGTON, D.C. APRIL 15, 1985

Today, of course, is tax day. I wish I could brighten the day by describing in detail the new tax system that the President soon will be recommending to the Congress. But I cannot. The Treasury consultations have not yet been completed, and the President has not yet made decisions.

So I hope you will not mind if, rather than focusing on particular reform proposals, I offer a perspective on the reform movement which is giving rise to them.

The perspective is, as you will see, somewhat idiosyncratic. It gives greater weight to the political and sociological impetus for reform than it does to the power of economic theory. But in so doing, I think it makes a more persuasive case that reform clearly must come. (This perspective may give offense to some economic theorists. But I hope they may find some consolation in the greater confidence that reform is coming -- and that they may, therefore, take full credit one day.)

"Historic" Tax Reform

In each of the past two State of the Union messages, in countless campaign speeches, and most recently in his Saturday radio talk, the President of the United States has referred to the next stage in tax reform as "historic." That is a dramatic characterization.

But, of course, one must be skeptical of political rhetoric.

In a media world that seems to have little time for the ordinary, politicians often seek to distinguish themselves with rhetorical excess -- even when (or especially when) their substantive material is not quite up to distinction. Particularly since Viet Nam, Presidential rhetoric has had to bear a special burden of suspicion. The light that President Johnson claimed to see was at the end of too long a tunnel. And President Nixon's rhetoric compounded the problem. He showed too strong an attraction toward the false superlative and the hackneyed use of words like "historic." (One of my Nixonian favorites was his statement announcing the Smithsonian agreement of 1971. He termed it the greatest monetary agreement in the history of the world. It then lasted a little over a year!)

Even in understatement, President Nixon tended toward formulations that somehow strained credibility. One recalls rather vividly his reported remark upon seeing the Great Wall of China, "You gotta admit that's a great wall." And, of course, few have forgotten the classic: "I am not a crook."

Rhetoric has had understandable trouble keeping its once-fine reputation. Yet is is with some sensitivity to this point that I nonetheless call attention to President Reagan's use of the term "historic."

One might understandably ask whether the President's characterization is apt. Is comprehensive tax reform even likely to be enacted? (It has, in one form or another, been talked about for years -- without finding its way into law.) And if bold reform is to be enacted this year, as the President suggests, is it "historic" merely in the obvious sense? Or does its possible enactment reflect some deeper historical force -- which may be moving us toward action now? What is that force? And are those who would resist it likely to be successful?

I shall try to suggest answers to these questions as I touch upon the narrower subject of our tax reform program and its prospects.

Business As Usual?

From one perspective, this talk of bold reform might all be construed as business as usual. A President has proposed a study. But more than a year after the President's call for reform, he has not yet endorsed a specific legislative proposal, and the Treasury Department is still developing options.

At an abstract level, there is widespread public support for change. Indeed, it is said that there are only two categories of people with views about the current tax system -- and both sets of views are negative: those of men and those of women. Yet when it comes to particulars, there are at least as many categories of people who oppose reform as there are provisions in the tax code.

The prospects for stalemate -- or for degeneration into conventional incrementalism -- would seem to be dominant.

From another perspective, however -- the correct one in my view -- there is obvious reason to think there is more here than mere political puffery.

-- It is true that the President has not yet introduced his own detailed proposals. Those will be advanced in about a month. But he has established certain clear parameters. Among these, we take as given the following firm commitments:
   - we must reduce personal income tax rates substantially, bringing the top rate down to 35 percent, or lower if possible;
   - we must raise the personal exemption in order to provide greater fairness for families, and allow most families at or near the poverty line to be freed from income taxation altogether;
   - we must curtail unproductive tax shelters, and increase the perceived fairness of the tax system;

- o we must reduce corporate rates in a manner that is consistent with overall interests in capital formation;
- o we must preserve incentives for homeownership by preserving a home mortgage interest deduction; and
- o we must achieve reform on a basis that is revenue neutral (in static terms) -- that is, overall tax "reform" must produce greater fairness, simplicity, and growth, and not a tax increase in disguise.

Those who know the figures will appreciate that to be bound by these few basic parameters is inescapably to be driven toward major reform. Whatever number of options and refinements one may consider, in the end one is forced toward significant reform if one is to meet the President's basic tests.

-- It is true, as one would expect, that there is substantial resistance among those who seek to protect one special interest or another. That resistance is clearly visible. But it seems worth nothing that, in due course, representatives of the general interest -- the people -- can, and will, be mobilized. In this respect, it seems not insignificant to recall that the President was reelected with a 49-State electoral vote majority in a campaign that had only one clear and consistent substantive focus: The President said he wanted to bring personal income tax rates further down, not up.

-- It is true that because the President's specific reform proposals are still being developed, mobilization of public support -- the general interest -- has not yet begun in earnest. But that hardly means that the electoral mandate has been forgotten. And the time that has been devoted to refinement of options is time that has also been given to exploration of a basis for bipartisan consensus. I should emphasize that the quest for possible bipartisan consensus is not a deviation from the President's basic reform guidelines. It is, rather, an examination of options and refinements that are consistent with those reformist guidelines. So, when mobilization does begin, it will do so on a basis that has a better chance of growing and being sustained.

Strange Bedfellows

Even without full mobilization of potential popular support, there are already remarkable signs that something unusual may be happening here. The reform movement is quietly gathering momentum.

Public opinion polls show overwhelming popular support for tax simplification and tax fairness in the abstract. Some polls are also beginning to show substantial popular support even in the light of public exposure to less popular particulars.

And the business community, which most presumed to be negatively inclined, is beginning to show signs of support --

especially among those who pay high effective tax rates relative to other businesses.

But the more interesting phenomenon is the composition of the leadership contingent for the emerging tax reform movement. It includes some strange bedfellows:

-- A "conservative" Republican President who associates himself with President John F. Kennedy;
-- Ralph Nader and the Chairman of General Motors, who independently agree on the merit of "Treasury I"-type reforms; and
-- so-called "neo-liberal" and "neo-conservative" leaders in the House and Senate, as well as supposedly more "moderate" chairmen of the respective tax committees.

(Indeed, it appears that the tax reform movement may even bring the leaders of the Wall Street Journal's Washington bureau and its New York editorial page closer together!)

The Rise of Market-Oriented Populism

But what accounts for this emerging phenomenon?

Is it merely an intellectual recognition of the merit of so-called "supply-side" economic theory -- or any economic theory for that matter? I think not.

One of the most politically powerful of the reformist ideas is that marginal income tax rates must be reduced across-the-board. Yet this is arguably as much a "demand-side" idea as it is "supply-side." The matter can be argued round or flat, as sophistic geographers used to say.

One of the less politically powerful -- and much more politically contentious -- reform ideas is that the tax code should be neutral in its treatment of differing types of income and neutral in its effect upon different categories of investment. Insofar as this may be understood at all by the general public, I suspect it is not understood as an economic matter. Rather, it is understood as a matter of "fairness" (in its application to tax shelters, for example) and as a matter of Government's proper role -- involving the general questions of Governmental power to direct, influence, control, and intrude.

In any case, it seems implausible to suggest that economic "science" could be driving the reform movement. That so-called "science" is still in a primitive stage of development. Admittedly, it gained sufficient status in the sixties to become the subject of the Nobel prize. But in some ways that has proved embarrassing: The prize is given to economists who hold diametrically opposed views about the same empirical phenomena. This is understandable -- for, as Niels Bohr reportedly said, "Economics is harder than physics." But it is not only understandable, it seems increasingly to be understood. There is a widespread recognition of the now-obvious fallibility of economic "science," in its current condition. A healthy, correcting skepticism has arisen. And in the absence of definitive science, people have regained a degree of faith in practical experience and common sense.

Indeed, the political force for reform seems to be rooted more in a powerful frustration with the status quo than in new-found satisfaction with economic truths.

But what is the nature of that frustration? I suggest it is basically populist.

It is not a destructive form of populism, as has sometimes been known. Rather is seems, at this stage, to be a more benign and potentially constructive form. It is anti-elitist, opposed to excessive concentrations of power, oriented toward fairness and toward a degree of levelling.

It is also increasingly market-oriented. That, of course, has not been characteristic of past, American populist movements. But it is a natural corollary of the populists' distaste for concentrated power -- in a world where the concentration of power has shifted from private elites to governmental elites.

The focus of frustration ranges from the ridiculous to the sublime.

At the level of the ridiculous, one thinks of the recently mandated and soon-to-be-eliminated "contemporaneous logging requirements" (as they are known in Washington) -- that is, the paperwork required of farmers, salesmen, firemen, and others who use vehicles for both business and personal purposes. Intended in part to get at tax abuses by proverbial Mercedes-drivers -- abuses that populists might have condemned -- the regulations promulgated by the world of Washington somehow went awry, and created a populist backfire. The same was true of the failed effort to withhold taxes on interest and dividends.

These abortive efforts are symptoms of a tax system in trouble. Driven toward increasing complexity in the pursuit of compliance and a broader revenue base, the system is eroding its base of popular support. It seems almost to be bent on self-destruction.

At a more rarified level, the rising populist reaction is against the general phenomenon of governmental elitism gone awry. It is against the pseudo-sophistication of the "policy sciences." It is disappointed by the frustration of what proved to be the false hopes of the sixties. It is disenchanted by the well-intentioned failures of the "best and the brightest."

In this sense, it is represented intellectually by the rise of the political neo-ists -- the "neo-conservatives" and the "neo-liberals" -- both sets of which reflect a disenchantment with the liberalism of the recent past and an increasing appreciation of market-oriented policies. But fundamentally, the populist reaction is just that. It is not an intellectual movement.

The Rise of White-Collar Populism

This is not to say that the populist movement is not deep. In my view it is, but along a heavily emotional dimension. And it is, I think, broader than may conventionally be recognized.

It extends beyond stereotypical "blue-collar" and "red-neck" America -- well into the vast world of the white-collars. I do not mean merely to refer to the recently fashionable "Yuppies." Indeed, I mean particularly to focus on what often seem to be the forgotten white collar workers: the non-Yuppies, the ones who have made it to white collar clothes but not to Yuppie power or position, the "Rinso-blue collars" or the "pass-for-white-collars" so to speak.

Here, I think, are legions of quiet populists. We tend to forget how many "workers" are now "white-collar" -- that is, people, who dress more like professionals than like hard-hats. Excluding service workers, there are about 55 million white collar workers in America today -- double the number in 1960. They represent almost 55 percent of the workforce (compared to less than 30 percent for blue collars). Only a small fraction of these have "made it." Many of the rest are living out lives of frustrated hopes.

They are caught in what might seem a quiet con game. Many have worked their way "up" from blue-collar backgrounds. They have changed clothes; yet, in many respects, they have not significantly changed their place. And although it may not be clear on the outside, they know on the inside.

Joseph Heller captured one sense of this plight in his novel, Something Happened. Slocum, the white-collar anti-hero, reports on his worklife:

> In the office in which I work there are five people of whom I am afraid. Each of these five people is afraid of four people (excluding overlaps), for a total of twenty, and each of these twenty people is afraid of six people, making a total of one hundred and twenty people who are feared by at least one person. Each of these one hundred and twenty people is afraid of the other one hundred and nineteen, and all of these one hundred and forty-five people are afraid of the twelve men at the top. . . .
>
> At work, where I am doing so well now, the sight of a closed door is sometimes enough to make me dread that something horrible is happening behind it, something that is going to affect me adversely.
>
> Something must have happened to me sometime.

In Malamud's and Redford's The Natural, the hero's youthful professional hopes and promise are cut short. When asked to explain what happened, he can only say, "Things didn't turn out as I expected." In less heroic ways, that is what has happened to millions of white-collar workers: things haven't turned out as expected.

The Rise of Flat-Tax Populism

But what, one might ask, has the disappointment, frustration, and alienation of white-collar workers to do with tax reform? Presumably, they, like most, would welcome a tax rate reduction. But what would give such a conventional preference the emotional force to support a major reform movement?

I suggest that the latent emotional impetus for reform is tied to the sense that somehow the white collar world is a bit of a fraud. It is a sense not merely that the white-collar social pretense is misleading; but also that, for millions and millions of white-collar workers, they have somehow been victims of a con.

They are what one might think of as make-believe capitalists. They dress something like bankers or lawyers or brokers or executives. They go to work in office buildings or clean, high-tech facilities. Many own their own homes. (65 percent of all American households are now homeowner households.)

Many own shares of stock. (There are more than 42 million direct and 130 million indirect American shareholders now.) Most have checking accounts (88 percent of Americans do); credit cards (81 percent of Americans do); and savings accounts (71 percent of Americans do). Many have money market accounts and/or IRAs. They are sensitive to interest rates and have some basis for interest in financial markets. But -- and this is a big "but" -- they do not have much capital.

Indeed, they do not have much income from which to develop a store of capital. The median income for all male white collar workers -- including the real capitalists and the Yuppies -- is less than $25,000 per year. For female white collar workers it is about half that. Obviously, millions and millions of white collar workers must struggle just to make ends meet. It is no wonder that more than half of all white-collar workers seek professional tax-paying advice, and that an overwhelming majority (77 percent) feel they are paying too much to the Government.

Yet to achieve the implicit promise of the "rise" from blue-collar to white-collar, the capital-poor imitation capitalists know they need more than rate reduction. They need the benefits of strong economic growth as well. Those who people the worlds of Silicon Valley and Route 128 know the indirect value to them of incentives for entrepreneurship and risk-taking. But the overwhelming majority of white-collar workers don't work in high-risk environments. They live in risk-averse bureaucracies, which they know could be more daring and more efficient.

So it is easy enough to see how the white-collar majority would favor tax rate reduction and incentives for growth. Still, it is not quite so obvious why they would favor <u>flattening</u> the tax rate structure -- and why this should be construed as populist.

The reason would seem to be that flatter seems <u>fairer</u>. But why?

Of course, there is an easy claim of equity that can be made for a flat rate system. That, no doubt, appeals to some. But populists are supposed to be anti-elitists. And the question naturally presents itself: Why wouldn't they like a highly progressive tax system.

The answer, I think, is partly to be found in a point made earlier: The offensive elite in today's world is less a private elite and more a governmental elite. Further, many white-collar workers still aspire to join the private elite. But there is another element to the explanation: Larger numbers of people sense that the progressive tax system, in actual operation, is often not progressive -- and, somewhat ironically, in practice it seems unfair.

There may be a natural politico-economic law that excessively progressive tax systems must degenerate. They will either stifle incentive and have to be changed. Or, perhaps more likely, they will create a powerful incentive for the development of the deductions and shelters that undermine them. For most of our history, the percent of returns taxed at a marginal tax rate of 28 percent or more has been miniscule -- less than a fraction of one percent. It only reached 3 percent in 1960. But it has since risen to 6.5 percent in 1970; 12 percent in 1975; and 26

percent in 1980. And as it has done so, resistance in various forms has mounted.

But be a possible law of likely degeneration as it may, there are obvious unsettling aspects in the current system. The overwhelming majority of taxpayers eat lunch without being able to deduct their meals as business expenses. They buy baseball or hockey tickets without being able to enjoy the luxury of business-related sky-boxes. They talk on fishing boats, but don't take the tax deduction for ocean-cruise seminars. They strain to pay interest on their home mortgages and may take the tax deduction for their payments, but they can't quite figure out how others can invest in real estate shelters and get more back in tax benefits than is put at risk. They read that of those with gross incomes of over $250,000 before "loss," more than a fifth pay less than 10 percent in taxes; and of those with gross incomes over $1,000,000 before "loss," a quarter pay 10 percent or less in taxes.

From this perspective, it is little wonder than flatter would seem fairer.

And it is this perspective, too, which helps explain why there is popular interest in simplification, although the majority of lower- and middle-income taxpayers already have a rather simple tax system. What they want is simplicity for others as well. This is not a matter of altruism. Their interest in simplification is driven by resentment of the present system's unfairness -- their sense that others benefit from complexity, whereas they do not.

The Populist-Growth Connection

Populist resentment and the quest for fairness are powerful motive forces for reform. Without them, I doubt that "supply-side" and "neo-liberal" intellectual movements would have much practical effect. But with them, it seems clear to me that there is the grassroots political basis for reform.

That reform can rightly be viewed as "historic" -- as an outgrowth of rising market-oriented populism, and as a valuable correction on America's special path toward pioneering growth.

Pioneering growth will be advanced by a reformed tax system that reduces unproductive sheltering and encourages productive investment; and by a system that reduces marginal tax rates to stimulate work, savings, and productivity. But growth will also be advanced through the psychological contribution that tax reform can make to the overall sense of the system's fairness.

Populist resentment is not healthy -- except to the extent that it forces correction. But as it does, it may help unleash the vast productive energies of millions and millions of Americans who are now living lives of quiet frustration, alienation, and underproductivity.

Prospects

I believe that the intellectual underpinnings of the current tax reform movement are basically common-sensical and basically sound. But, as I have suggested, I do not believe that they are what is driving the movement. Nor do I believe that they, alone, would be sufficient to sustain the movement.

In a democracy, large-scale, non-incremental reform requires a broadly-based, emotionally-driven, popular appeal. Populist resentment, the new populist appreciation of market-oriented growth, and the populist quest for fairness are the basis for just such an appeal. Their convergence with "supply-side" and "neo-liberal" ideology is fortuitous. I doubt that they -- and the historic reform movement of which they are a part -- can be denied.

While I may not have fully demonstrated this point in these remarks, perhaps there is significance in the very fact that a retrograde Harvard elitist and confessed pragmatist would appear before this distinguished and sophisticated audience to sing the praises of populism!

Thank you very much.

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Statement of the
Honorable James A. Baker, III
of the United States of America
Concerning Partnership for Growth
Before the Meeting of the
OECD Council
at Ministerial Level
April 12, 1985
Paris, France

Chairman Wilson, Secretary General Paye, Distinguished Colleagues.

Partnerships for Growth

Yesterday our discussions focused on issues relating to economic growth and adjustment in developing countries, and on problems and prospects in the world trading system. In many respects today's topic -- the OECD economies in the 1980's -- is a discussion of ways in which our policies, macroeconomic and structural, can help lay the basis for progress in both of these areas. The choice we make to secure sustained, non-inflationary growth for the rest of the decade will help shape the economic environment in which the LDCs operate. The policies we choose will also affect the capability of our economies to adjust to economic change and will help determine our ability to resist trade protectionist pressures.

Our primary economic goal must be to establish the best possible climate for sustained, non-inflationary, job-creating growth -- to maximize the opportunities for our people to find jobs, to increase their standards of living, and to realize their full potential. We must choose policies which unleash the strength of the free enterprise system so that our economies can regain their vitality and flexibility to adapt to changing conditions.

We need a new commitment to growth throughout the OECD area, not the temporary kind of growth brought about by government "pump priming" but the durable, sustainable growth created by private sector investment and production, in a free, market-oriented environment. Each of us faces individual problems that only we ourselves can solve. But we have a common interest in their solution. Acting constructively on our individual problems, we can create an environment in which the whole is greater than the sum of its parts -- and in which we become true partners for growth.

Current Situation

The OECD economies are in their strongest position in many years. The widely accepted view of the seventies was that industrial country inflation rates near the double-digit range were the best that we could expect. But over the past four years, we have fundamentally altered our inflation outlook. The average inflation rate in the OECD area is the lowest since 1972, immediately preceding the first oil shock.

In addition to these inflation gains, the recovery in our economies has solidified. Led by the strong recovery and expansion in the United States, the OECD is now in its third year of expansion. Further, the disparities in growth among our countries are narrowing significantly. Last year's average growth was the strongest since 1976. Projections indicate that solid real growth will be recorded this year and next. And importantly, inflation rates will stay at low levels so long as we continue to pursue sound and stable monetary and fiscal policies. This could be the only period since the early sixties when inflation rates four years into a recovery are lower than at the beginning of the recovery.

We should be proud of these important improvements in the economic climate. We have, working together, laid the foundation for a sustained, non-inflationary expansion. We now need to build on that foundation the basis for continuing growth and for sharing the benefits of expansion.

Challenges/Opportunities

Despite the impressive gains, all of us face challenges and opportunities over the next few years. As policy-makers, each of us must build the domestic support needed to tackle serious problems before us. While the problems are not the same in all our countries, the solutions are all aimed at assuring that the current expansion is sustained in a manner which creates new jobs.

I see three broad areas in which all of us need to improve our performance: fiscal policy, trade liberalization, and structural adjustment. Only a few OECD members have successfully reduced their level of government expenditures and budget deficits significantly. The rest of us must follow through on our commitments to reduce the size of government to free up needed resources for the private sector.

There is no question that we must all move forward on trade liberalization. Our economies will all benefit from the more efficient allocation of resources brought about through free trade flows. The ability of the LDCs to continue their adjustment programs depends importantly on open market in our countries.

Increased economic flexibility will also result from efforts to reduce the structural rigidities which all of our economies face. Structural barriers need to be removed to allow market signals to determine business decisions such as hiring, firing, investment choices, interest rate determination, and the like. We do not see structural adjustment as a way to increase government's role in our economies. Instead, we view it as a process that removes government interference from the marketplace and returns economic choice to private citizens.

While all of us need to redouble our efforts in these basic areas, I believe that troublesome areas are of different importance among our countries.

For the United States, the major challenge is to reduce the budget deficit in a way consistent with sustained real growth. I have worked closely with President Reagan for four years. I can assure you that he is deeply committed to reducing the budget deficit. This commitment was very clear in early March when the Congress passed farm legislation that exceeded the President's budget proposals. All of you understand the political power of farmers. And you have read about the serious financial difficulties American farmers are experiencing. So you would appreciate the political risks of rejecting farm legislation. Yet President Reagan did just that. He vetoed the farm spending bill. I am certain that the President will continue to show that same degree of courage throughout his second term.

I am optimistic that the President and the Congress will reach an agreement on a budget package that will reduce the projected deficit substantially. The Senate leadership and the Administration have recently worked out a package of budget cuts that would reduce our projected deficits by $52 billion in the next fiscal year and by $300 billion over the next three years. If enacted, this package would result in a deficit of less than two percent of the GNP by 1988.

Spending cuts are the best course of action to reduce the deficit. They are the only way to reduce the size of government and to release funds to the private sector. And only cuts achieve lasting reductions in the presence of government in our economies. Raising taxes is not a satisfactory approach. Indeed, we also intend to enact a comprehensive reform of our tax system that will bring tax rates further down, not up. This is consistent with our general interest in increasing incentives for work, saving, and investment.

We accept the responsibility for reducing our budget deficit. But at the same time we should all recognize the contributions the United States has made to the global economy.

-- Our European colleagues have experienced a major boost in demand through our rapidly expanding imports. European exports to the United States rose 32 percent last year. The U.S. expansion has accounted for nearly one-half of the real growth of the major European countries.

-- And the LDCs would not have survived their recent financial problems without the rapid 37 percent growth of exports to the United States.

I hesitate to speculate on where we would all be if the U.S. economy had not provided that growth. We intend to assure that our growth continues.

Let me suggest areas in which policy action by others would also help the global economies.

If the European and Japanese economies are to supplement the United States in supporting LDC adjustment efforts, their imports from LDCs will have to increase significantly. Their combined imports from LDCs would have to rise by $25 billion to equal the growth stimulus ignited by the U.S. expansion. This would represent a growth of some 25 percent in the level of Japanese and European imports from LDCs.

Our Japanese colleagues face difficult challenges and opportunities. For more than a decade Japan has been the second largest economy in the OECD. Its solid growth performance has been built upon the ability of Japanese firms to reap the advantages of the free liberal trading system. All of us can learn from the success stories of the Japanese firms in the world marketplace.

But the free and liberal trading system is based on the concept of comparative advantage. It assumes that trade is free to flow in both directions -- that's what comparative advantage is

all about. No country has a comparative advantage in all it produces. A country's openness to imports is the cost of gaining the benefits from exporting opportunities. The gains from free trade come from the balance of costs and benefits of imports and exports. All countries need market access to pay for their own imports.

It is time for Japan to accept the responsibilities of free trade that coincide with the benefits.

In Europe, the current expansion has not succeeded in reducing unemployment rates. You are unhappy with this result and so am I. It is our view that the ability of European economies to create jobs will not improve unless you address fundamental structural rigities in your economies. I believe that it is critical that you remove impediments to hiring and firing of workers so that firms possess flexibility and economic incentives to create new jobs. Firms need to be able to raise capital in the most efficient way possible. Removing capital market controls and rigidities would produce a better allocation of capital within economies. Increasing competition in domestic capital markets will provide important gains in financial markets flexibility. And in labor markets, disincentives to job search must be removed and marginal tax rates must be lowered so that workers have an economic reason for seeking new jobs.

Without substantially increased flexibility and market-oriented decision making in Europe, job creation will remain disturbingly low. This hurts the U.S. economy as well as European economies. It reduces demand for our exports and adds to our trade and current account deficits. And, a low-growth, high-unemployment European economy increases trade protectionist pressures in America and Europe.

Because of the importance of structural adjustments, we need a heightened effort in the OECD throughout 1985 and early 1986 to bring about a fuller understanding of the relationship between structural adjustment measures and improved economic performance.

On one track, we would ask the secretariat to start work immediately on an analytical paper on the linkages between structural adjustment and economic performance. The paper should be designed to inform the policy debate and improve public understanding of the issues. This work could be monitored by the Economic Policy Committee, with review by other committees as appropriate, and forwarded to the 1986 ministerial.

On a second track, we would ask the various committees to exchange views on national experiences with structural adjustment measures. This should lead to a progress report to ministers next year based on actual experience.

This approach will enable the OECD to break new ground in analyzing an extremely relevant issue. Our efforts would provide solid evidence to the public that OECD governments are seriously tackling the obstacles of employment creation and stronger economic growth.

Before concluding, Mr. Chairman, I would like to say a few words concerning a matter of interest to all members of the OECD as well as to developing countries. I am speaking of the operation of the international monetary system.

As many are aware, the Group of 10 has been conducting a major review of the international monetary system for almost two years. The G-10 studies are not yet completed, and it is therefore not possible to know at this stage exactly what the conclusions may be. The current system has served us well in many respects over the last turbulent decade, but this is not to say that the system is without weaknesses. We understand the G-10 studies will conclude that a major reform is not necessary, but that a number of concrete, pragmatic steps should be taken to strengthen the current system.

The G-10 Finance Ministers and Central Bank Governors will review the results of these studies in June. The United States attaches considerable importance to this work, which we expect will represent a sound basis for improving the monetary system. Therefore the United States is prepared to consider the possible value of hosting a high-level meeting of the major industrial countries, following the conclusion of the G-10 studies, in order to review the various issues involved in transforming the findings of the G-10 into appropriate action.

The meeting could center around one of the major conclusions that appears to be emerging from the studies -- that the key to greater external stability is internal policies that promote convergence toward non-inflationary growth. Such stability can only be achieved in a lasting way by strengthening our cooperative efforts to promote sound underlying policies and performance. The studies point toward the need to strengthen IMF surveillance as a means of encouraging such policies and performance.

A special meeting could, therefore, build on the G-10 studies by considering, in a cooperative fashion, the policies and performance in the major industrial countries, and how these can be improved to promote convergence toward non-inflationary growth. In this connection, the implementation of concrete, specific arrangements to strengthen IMF surveillance, including multilateral surveillance, could be discussed.

The G-10 studies are not limited only to matters of underlying policy and convergence of performance -- they also cover such issues as international liquidity, the role of the IMF, and certain aspects of the debt problem. Each of these areas could be considered at the special meeting.

Such a meeting would not in any way be linked to negotiations to liberalize the international trading system. As we said yesterday, trade negotiations can and must proceed on their own merits. It is clear that discussions on international monetary issues are in fact, already well advanced. We should build on the work already done in the monetary area. We should also move quickly and independently to assure that trade liberalization is not left behind.

Conclusion

In concluding, Mr. Chairman, I would like to reemphasize that assuring a durable non-inflationary expansion is the fundamental task. Progress in all of the areas I have discusses is essential to accomplishing that task.

In the highly interdependent world of the eighties we must move forward together. As each of us makes our best effort to solve our respective problems, we can become true partners for growth.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
April 17, 1985 9:00 A.M., E.S.T.

Statement by
Robert A. Cornell
Deputy Assistant Secretary
for Trade and Investment Policy
Department of the Treasury

Before
Subcommittees on Africa and
International Economic Policy and
Trade Committee on Foreign Affairs
House of Representatives

April 17, 1985

Chairmen and Members of the Subcommittees:

I appreciate the opportunity to present the Treasury Department's views on legislation recently introduced in the Congress on South Africa. Officials of the Department believe the apartheid policies of the South African Government are repugnant and we, like members of the Congress, would like to see their total abolition. We also recognize that there is a strong and apparently growing desire in America to express our opposition to South African racial discrimination.

We view legislation proposed by members of Congress as a sincere attempt to respond to this desire and to develop a statement of opposition to South Africa's apartheid policies. However, the Treasury Department cannot support,

and must oppose, the types of punitive economic measures proposed in the legislation for several reasons.

First, we believe the proposed measures will not produce the desired changes in South Africa's system of apartheid. Moreover, they would have unintended but adverse effects on the non-white South African population we wish to help, and would harm, perhaps significantly, U.S. commercial interests.

Second, the proposed measures contradict basic objectives and tenets of this Administration and would undermine the Administration's efforts to minimize government intervention in markets and government controls on firms, and in the international area to promote free and open capital markets.

Since the statements of Assistant Secretary of State Crocker and Deputy Assistant Secretary of Commerce Kelly cover in detail foreign policy considerations, embargoes on trade and services, codes of conduct and federal contracts, I would like to concentrate my remarks on five specific areas of particular interest to the Treasury. They are:

- ban on bank loans;
- disinvestment and ban on new investment;
- ban on imports of krugerrands;
- denial of tax credits to U.S. firms operating in South Africa; and
- requirement that U.S. Executive Director of the IMF vote against loans to South Africa.

My coverage of these fives areas will include responses to specific questions raised by the Subcommittees in their letter inviting Treasury's views.

Ban on Bank Loans

The Treasury Department strongly objects to a ban on loans by U.S. banks and other financial institutions (including insurance companies), directly or indirectly through a foreign branch or subsidiary, to the South African Government or to any corporation, partnership, or other organization owned or controlled by the South African Government. These prohibitions interfere with the free movement of capital, in

effect imposing discriminatory exchange controls, which the Administration opposes except in situations involving national emergencies. Adoption of prohibitions on bank lending would undermine the Administration policy that international capital markets should remain free of government interference and that lending decisions should be based on market rather than political considerations.

Restrictions on U.S. bank lending to South Africa could be viewed both at home and abroad as evidence of the U.S. readiness to use capital controls routinely for political ends. Their imposition could erode international confidence in the security of foreign investments in this country and thus impair the implementation of our monetary and financial policies. Restrictions on foreign subsidiaries of U.S. firms might place these firms in conflict with laws of third countries--creating resentment about and inviting retaliation against--what would be considered an extraterritorial reach of U.S. law.

Bans on U.S. bank lending to South Africa could set a dangerous precedent for imposing politically-motivated restrictions on lending to a variety of other countries. For example, such restrictions could also be extended to Eastern European or sub-Saharan African countries which have adopted political or economic policies that are not congruent with our own.

As a practical matter a ban on bank lending is likely to be ineffective. It is likely that other countries' banks would replace U.S. banks as lenders. U.S. banks only account for about twenty-five percent of total bank claims on South Africa as reported by the Bank for International Settlements (BIS), and only a small portion of U.S. bank claims (under seven percent as of end September 1984) represent lending to the South African public sector.

Since capital is fungible, some perverse results could emerge with a ban on U.S. lending. An increase in loans by other countries' banks could be indirectly funded by borrowing from U.S. banks. Attempts to establish a surveillance system to prevent such occurrences would be extremely difficult if not impossible to administer, and would be very costly. Any such attempts would also create further distortions in international capital markets with the ultimate result of harming U.S. financial interests.

Much U.S. bank lending to South Africa finances U.S. exports. A ban on lending would reduce U.S. exports, domestic production and employment, and have a negative effect on our balance of trade.

Bans on U.S. bank loans to South Africa might also limit the availability of foreign exchange for financing of South Africa's reexports of food and other supplies to other African countries.

Disinvestment and Ban on New Investment

The Treasury opposes legislation banning new U.S. investments in South Africa or requiring disinvestment by established U.S. investors, for much the same reasons that we oppose a ban on bank lending:

-- it would conflict with our longstanding market-oriented policy towards investment, and would undermine our efforts to extend that policy internationally; and

-- it would set a precedent for banning U.S. investments in other countries whose policies are strongly opposed in the United States.

Like a ban on bank lending, a ban on new investments in South Africa and/or a requirement that U.S. firms disinvest could produce rather perverse results for non-whites in South Africa and for U.S. firms with operations in South Africa. U.S. firms operating in South Africa are a major employer of non-whites and a major source of pressure for change in South Africa's policies. Limiting the ability of these firms to bring in new capital, to grow or to adjust to market conditions, or requiring that they leave South Africa, would reduce job opportunities for non-whites and limit or, in all probability, remove the many improvements enjoyed by non-white employees of U.S. firms on the job and off the job in areas such as housing, education and health. Recent polls indicate that the majority of non-white South Africans recognize the potential negative consequences for them of bans on U.S. investment in South Africa or of U.S. disinvestment--they oppose these measures.

U.S. firms could also be placed in a precarious position by bans on new investment or a requirement to disinvest. A large portion of U.S. investment in South Africa is in high growth areas--the automotive, pharmaceutical, petrochemical and computer sectors. In these sectors there are

numerous competitors, both foreign and local South African. A ban on new investments would limit established U.S. firms' capacity to adjust to market changes--such as the current economic stagnation in South Africa--and may force many to withdraw. Depending upon the nature of the firm's business and the prevailing economic conditions, a withdrawal, prompted by limits on new investment or by required disinvestment, could be extremely costly to the firm, both at the point of withdrawal and subsequently. Firms might be forced to sell their assets at a price well below real value. In addition, potential host countries to and potential customers of foreign subsidiaries of U.S. firms would not miss the fact that U.S. firms were forced, because of political judgements in the United States, to leave South Africa. They would likely take this into account in deciding whether to permit U.S. investment in their countries or whether to buy from U.S. firms.

Even if a ban on new investments did not lead to closure of U.S. operations in South Africa, it would preclude investments by U.S. firms not there now. This would create a segmented and discriminatory grouping of U.S. firms--those with operations in South Africa and others. This is clearly not acceptable.

Finally, while the U.S. is the third largest source of direct investment in South Africa ($2.3 billion year-end 1983; 17 percent of total foreign direct investment in South Africa), an ending of new U.S. investment flows or the sale of existing capital assets is not likely to create serious problems for South Africa. Other countries (Japan, the United Kingdom, West Germany) have significant commercial interests in South Africa, and their firms would quickly fill gaps left by departing U.S. firms. South Africa also has demonstrated its ability to develop efficient indigenous production in the face of international sanctions, such as in its arms industry.

Ban on Imports of Krugerrands

Treasury opposes a prohibition on the importation of South African krugerrands. While the prohibition would be a symbolic gesture it would be an ineffective gesture, and it may place the United States in violation of our international obligations under the General Agreement on Tariffs and Trade (GATT).

A prohibition of imports from an individual country, such as South Africa, would normally be considered a discriminatory trade measure under the GATT. It could leave the United States open to a complaint in the GATT from South Africa, and the possibility of GATT sanctioned countermeasures by South Africa.

The proposed ban on imports of South African gold coins would probably not result in a corresponding reduction in U.S. gold demand or imports of foreign gold. Americans would still be able to purchase and hold krugerrands abroad, and new marketing efforts would undoubtedly be developed in an effort to get Americans to do so. Americans could also switch from buying krugerrands to purchasing coins and gold pieces of other countries, such as Canadian maple leafs. South Africa would still benefit after such switching, since gold for the production of most foreign coins is purchased in the market to which South Africa supplies about 60 percent of newly mined non-Soviet gold. South Africa has not allowed changes in demand for krugerrands to affect the amount of its gold production that is sold, as it views bullion and coin sales as interchangeable.

In the final analysis, a ban on U.S. krugerrand imports would affect South African earnings from gold sales only to the extent that such a ban would have a negative impact on gold prices. If Americans switched to buying krugerrands abroad or to foreign coins produced by gold purchased in the world market, the overall demand for gold would not be changed and the price would not be affected. However, if Americans were to switch to purchasing coins minted from gold in official reserves, the price of gold would tend to decline because of the increase in supply to the world market.

Any downward pressure on gold prices consequent to a U.S. ban on krugerrand imports is not likely to be strong. Even in the extremely unlikely event that the demand for South African gold coins fell by the full equivalent of 1984 annual U.S. imports of about 1.3 million ounces, this would be small relative to the 36 million ounces of newly mined gold supplied to the market last year.

<u>U.S. Vote Against IMF Loans</u>

Treasury is opposed to the proposal to require the U.S. Executive Director of the International Monetary Fund (IMF) to vote automatically against any proposed IMF loan

to South Africa. This requirement would be both damaging to important U.S. interests in the IMF and an ineffective tool against apartheid.

The IMF was created to promote global economic and financial stability, an objective that is in the broadest U.S. economic and foreign policy interest. The Fund's success in achieving this objective is due in large measure to its strict focus on economic and financial issues, and to its consistently even-handed treatment of its members despite the fact that its membership comprises countries with widely divergent economic and social systems. The United States has strongly supported this approach through Democratic and Republican administrations alike.

Each IMF member has certain rights in the Fund (such as the right to make use of IMF financing) and each must fulfill certain obligations (such as the obligation to cooperate with the Fund in connection with IMF loans). Efforts to limit selectively the rights of certain members in the Fund would rapidly undermine their willingness--and the willingness of other members as well--to meet their important obligations to the Fund. This would seriously impair the Fund's ability to play its crucial role in the international system. Moreover, steps by the United States to tamper with the IMF's basic apolitical character would certainly trigger similar actions by other countries, with potentially damaging implications for U.S. friends and allies. Ultimately, the IMF could degenerate into just another highly politicized and ineffective international institution.

The special concerns of Congress on the question of apartheid, as well as the need to protect the IMF's essentially technical economic character, are reflected in the recently enacted legislation approving U.S. participation in an increase in the resources of the IMF. This legislation establishes special criteria which must be considered by the United States prior to approval of any proposed IMF loan for South Africa, but specifies these criteria strictly in economic terms. Thus, the U.S. Executive Director to the IMF may support a proposed IMF loan to South Africa only after making a determination that the loan will improve the balance of payments situation by reducing constraints on labor and capital mobility, and benefit economically the majority of the population.

The United States has, consistent with the spirit of this legislation, urged the South Africans to reduce constraints on labor and capital mobility which contribute to

balance of payments deficits and to expand education and job training programs. In our view this approach is a sound one and offers the best prospects for an IMF role in reducing apartheid that is both influential and consistent with the other important objectives I have outlined.

Denial of U.S. Tax Credits

The Treasury Department opposes the proposed denial of foreign tax credits for South African taxes because it violates both U.S. treaty obligations and sound tax policy.

The United States taxes U.S. citizens and residents, including U.S. corporations, on their worldwide income. When a portion of that income is earned in a foreign country, the foreign country will generally also tax the income. As a result, the same items of income may be subject to double taxation. To avoid such international double taxation, the United States permits foreign taxes paid on income earned outside the United States to be credited against U.S. tax. To preserve the U.S. tax on U.S. income, the foreign tax that may be claimed as a credit is limited to the U.S. tax that would otherwise be due on the foreign income.

For a U.S. company with excess foreign tax credit limitation, the proposed denial of credits would result in the double taxation of income earned in and taxed by the Republic of South Africa. The combined U.S. and South African tax rate on this income could be as high as 85-90 percent as a result of the proposal.

The United States foreign tax credit is based on sound tax policy. It conforms with accepted international practice by according to host countries the primary right to tax income earned in that country. The United States obligation to relieve international double taxation of income earned by citizens, residents and corporations in South Africa is confirmed in our income tax treaty with South Africa which would be directly violated by the proposed legislation.

Conclusion

In summary, we recognize the pressures to respond strongly to South Africa's policies, and the Congress's genuine attempts to develop a response. However, when the Treasury examines the types of measures proposed in legislation, largely punitive

economic actions, in terms of their potential for promoting change and their effects on U.S. interests and the interests of non-whites in South Africa, we cannot support, and must oppose, them. We believe the proposed measures would not produce the changes we all seek, but would further disadvantage the non-white population in South Africa and would have adverse effects, perhaps significant and long-standing, on U.S. commercial interests.

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TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. April 16, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,000 million, to be issued April 25, 1985. This offering will result in a paydown for the Treasury of about $50 million, as the maturing bills are outstanding in the amount of $13,042 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Standard time, Monday, April 22, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,500 million, representing an additional amount of bills dated January 24, 1985, and to mature July 25, 1985 (CUSIP No. 912794 HT 4), currently outstanding in the amount of $7,073 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,500 million, to be dated April 25, 1985, and to mature October 24, 1985 (CUSIP No. 912794 JD 7).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing April 25, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,266 million as agents for foreign and international monetary authorities, and $1,829 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

April 17, 1985

Ronald A. Pearlman Confirmed
Assistant Secretary of the Treasury for Tax Policy

Ronald A. Pearlman was confirmed by the United States Senate as Assistant Secretary of the Treasury for Tax Policy on January 31, 1985. He signed the oath of office on February 22, 1985.

Prior to his nomination, Mr. Pearlman served as the Deputy Assistant Secretary of the Treasury for Tax Policy from July 1, 1983, until his swearing in as the Assistant Secretary.

Mr. Pearlman has the principal responsibility for the formulation and execution of United States domestic and international tax policies.

Prior to joining the Treasury, Mr. Pearlman was a partner in the St. Louis law firm of Thompson & Mitchell and served as an adjunct professor of law at Washington University School of Law, St. Louis.

Prior to joining the St. Louis law firm, Mr. Pearlman served in the Office of the Chief Counsel of the Internal Revenue Service from 1965-69.

Mr. Pearlman earned a B.A. degree from Northwestern University in 1962, and received his J.D. degree from Northwestern's Law School in 1965 where he was on the Board of Editors of the Northwestern University Law Review. In 1967, he earned an LL.M. degree in Taxation from Georgetown University Law Center.

A frequent lecturer at various tax institutes, he has also written a number of articles on tax subjects.

Mr. Pearlman served as the Chairman of the Missouri Bar Taxation Committee from 1976-78, and Chairman of the Advisory Committee, Director of Revenue, State of Missouri from 1978-79. Chairman, 1979 Mid-America Tax Conference.

Mr. Pearlman is a member of the American Bar Association, the American Law Institute, and The Missouri Bar.

Mr. Pearlman and his wife Hedy have two children, Steven and Leslie.

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TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

ORAL STATEMENT BY THE HONORABLE JAMES A. BAKER
SECRETARY OF THE TREASURY
OF THE UNITED STATES
CONCERNING
A BLUEPRINT FOR GLOBAL GROWTH

BEFORE THE
MEETING OF THE INTERIM COMMITTEE

APRIL 17, 1985
WASHINGTON, D.C.

Chairman Ruding, Managing Director de Larosiere, fellow Governors:

I welcome this opportunity to participate in this special meeting of the Interim Committee. I must admit that when I first came to Treasury I wondered if Don Regan had left me a golden opportunity or an impossible task when he proposed that the Interim and Development Committees engage in an informal dialogue on medium-term growth, adjustment, and development.

But as I have dealt regularly over the past two and a half months with the need to ensure continued low inflation growth in the U.S. economy, I've become convinced that an informal dialogue is precisely what we need to understand better how each of us can contribute to achieving stronger and more balanced global growth. We all want growth for our economies -- not stop-go spurts of growth and recession punctuated by periods of high inflation, but sustained growth. Jobs we can count on. Markets we can depend on. Creditworthiness that can be maintained so that credit is there when needed.

B-93

Those aren't such impossible goals. But they require considerable thought and medium-term planning. And that's what these meetings are designed to permit us to do:

To talk to one another -- frankly and off the record -- about the progress achieved in recent years in the face of very difficult problems.

More importantly, to listen to one another, and thereby to understand better the underlying economic situation in each of our economies, as well as our fundamental interdependence.

To review the prospects for the rest of the decade, considering what policies might help assure sustained, low inflation growth.

And to help build a consensus about what each of us can and will contribute to that common objective.

Our task, in sum, is to develop a "blueprint" of policies for global growth to which each of us can contribute and from which all of us will benefit. This does not mean identical policies in all countries. Our economies vary immensely, have different needs, and can draw on unique strengths. But we all <u>can</u> and must play a role in assuring that growth spreads and is sustained.

Sustained growth among the industrial countries is clearly the cornerstone for global growth. It is more important to the developing countries than any conceivable rise in development assistance or lending by the international institutions.

The United States and other industrial countries have already made substantial efforts which are reaping benefits in reducing inflation, cutting government spending, and allowing markets a greater role in our economies. U.S. expansion alone since 1982 has directly increased non-oil LDC exports by $25 billion. U.S. growth also created a 32 percent increase in European exports to the United States last year, and has accounted for nearly one-half of the real economic growth of the major European countries.

A number of developing countries have also made considerable efforts to correct their payments imbalances. Through the use of a range of policies, particularly sound monetary, fiscal, and exchange rate policies, these countries have in most cases restored growth, slowed inflation, and reduced sharply their balance of payments deficits. I find it particularly encouraging that output in non-oil developing countries rose by 4.5 percent in 1984, while their exports grew by 12 percent and their imports by nearly 6 percent.

Our task now is to assess the progress that we've made, and to determine how to direct our efforts to consolidate and build on that progress.

The United States will do its part. We must follow a steady, anti-inflationary monetary policy. And we are determined to reduce substantially the U.S. budget deficit. The President has recently secured an agreement with the Senate leadership on a deficit reduction program that, if implemented, will ensure a $300 billion reduction in our deficit over three years. We are also fully prepared to put current U.S. trade restrictions on the table as part of a new round of trade negotiations, provided others will do the same, as a means of reducing protectionist pressures and benefitting global growth.

But as U.S. growth slows somewhat to a more sustainable level in the years ahead, economic developments in Europe and Japan will become even more crucial in supporting the adjustment efforts of the developing countries. Efforts to reduce further government expenditures, to maintain anti-inflationary monetary policies, and to free up and open up their economies can and must make a significant contribution to LDC and global growth in the medium term.

While sustained growth in the industrial world can facilitate growth elsewhere, it obviously cannot make growth happen. The

policy choices of individual developing countries will determine whether or not they can take advantage of the opportunities that are presented. In addition to sound monetary, fiscal, and exchange rate policies, more active use needs to be made of pricing, marketing, and wage policies; trade and financial market liberalization; and efforts to improve the environment for foreign direct investment. All of these can contribute importantly to LDC growth and adjustment.

Turning to the question of an SDR allocation, the United States continues to oppose an allocation. We frankly don't see that international liquidity and reserve developments demonstrate a need for it.

Our discussions this afternoon will include consideration of ways to strengthen IMF surveillance generally and to develop "enhanced" surveillance for certain debtor countries. We firmly believe that IMF surveillance can play a key role in encouraging the adoption of sound economic policies in all of our countries, through both regular and special consultations with individual countries, as well as through multilateral surveillance. I hope others will join us in supporting measures to strengthen IMF surveillance.

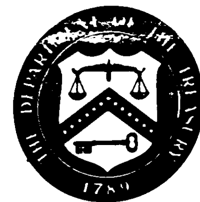
The studies regarding the international monetary system which have been underway within the Group of Ten recognize the need for

more effective IMF surveillance, and are likely to emphasize specific proposals toward that end. As I indicated last week, the United States attaches considerable importance to these studies of possible improvements in the international monetary system. We are therefore prepared to consider the possible value of hosting a high-level meeting of the major industrial countries, following the conclusion of the studies, in order to review the various issues involved in transforming their findings into appropriate action.

Such a meeting could provide further impetus to strengthening the international monetary system through the IMF, in particular through the upcoming review of the G-10 studies by the IMF's Interim Committee. For while the major industrial countries must do their part to strengthen the system, we cannot do it alone. It will be necessary for each of us, industrial and developing countries alike, to accept our responsibilities to improve the system.

This is reflected in the fact that it is the Interim Committee, representing the entire membership of the IMF, that has the responsibility, among others, to advise and report to the Board of Governors with respect to "the management and adaptation of the international monetary system...." It is this Committee, then, that will have the basic task of considering how the G-10 studies can best be implemented to strengthen the international monetary system.

I look forward to this afternoon's informal session as an opportunity to discuss frankly the key policy issues for the medium-term. I intend to approach these discussions positively and constructively, and I trust each of you will do the same. Being positive and constructive does not necessarily mean agreeing to this or that financial concession. A focus on such concessions can distract us from the real issues and from what this meeting is about -- listening, learning, and understanding better what each of us can do to establish a firm basis for sustained growth. Through such understanding, we can develop a blueprint for global growth that can help ensure a more productive and prosperous future for us all.

TREASURY NEWS 
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. April 17, 1985

TREASURY TO AUCTION $9,000 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $9,000 million of 2-year notes to refund $8,225 million of 2-year notes maturing April 30, 1985, and to raise about $775 million new cash. The $8,225 million of maturing 2-year notes are those held by the public, including $360 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $9,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $347 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-94

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED APRIL 30, 1985

April 17, 1985

Amount Offered:

To the public	$9,000 million

Description of Security:

Term and type of security	2-year notes
Series and CUSIP designation	Series U-1987 (CUSIP No. 912827 SC 7)
Maturity date	April 30, 1987
Call date	No provision
Interest rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	October 31 and April 30
Minimum denomination available	$5,000

Terms of Sale:

Method of sale	Yield Auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None
Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

Key Dates:

Receipt of tenders	Wednesday, April 24, 1985, prior to 1:00 p.m., EST
Settlement (final payment due from institutions)	
a) cash or Federal funds	Tuesday, April 30, 1985
b) readily collectible check	Friday, April 26, 1985

'REASURY NEWS
artment of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 a.m. E.S.T.
April 30, 1985

STATEMENT OF
DENNIS E. ROSS
ACTING DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON COMMERCE, TRANSPORTATION, AND TOURISM
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on the Federal income tax policy issues raised by the proposed sale by the Federal government of its interest in the Consolidated Rail Corporation ("Conrail") to Norfolk Southern Corporation ("Norfolk Southern"). We have not comprehensively examined all potential Federal income tax consequences of the proposed sale, but have limited our analysis to certain issues of tax policy raised by the Federal government's ownership of Conrail and the form of the proposed transaction. In addition, our analysis is based on the details of the proposed transaction reflected in the Memorandum of Intent signed February 8, 1985 by Norfolk Southern and the Department of Transportation, and in H.R. 1449 and S. 638, pending legislation that would authorize and establish terms for the sale of Conrail.

Background

Section 401 of the Regional Rail Reorganization Act of 1973 enacted by the Northeast Rail Service Act of 1981 directed the Secretary of Transportation to submit to the Congress a plan for

the sale of the Federal government's interest in approximately 85 percent of Conrail's common stock to (1) ensure continued rail service; (2) promote competitive bidding for the stock; and (3) maximize the government's return on its investment in Conrail. After careful review of a number of purchase proposals, the Secretary of Transportation has recommended sale of Conrail to Norfolk Southern.

The Treasury Department has consulted closely with the Department of Transportation with regard to the tax policy aspects of the sale of Conrail. Our advice to the Transportation Department has been guided by two basic policy objectives: (1) that the sale of Conrail should not provide the purchaser with Federal income tax benefits that would not be available in an analogous transaction between private parties; and (2) that the Internal Revenue Service ("IRS"), in its role as administrator of the Federal income tax laws, should not be prevented by the sales agreement or enabling legislation from treating Conrail in the same manner as any other taxpayer.

Treatment of Conrail's Tax Benefits

Under current law, there are significant differences in the Federal income tax treatment of a sale of stock and a sale of the assets of a corporation. In general, a purchaser of the stock of a corporation receives a tax basis in the stock purchased equal in amount to the consideration paid for such stock. Other than this change in tax basis for the stock purchased, the sale of stock of a corporation generally does not trigger tax consequences either to the purchaser or to the corporation whose stock is sold. Accordingly, the existing tax attributes of the acquired corporation generally remain intact even though the corporation is owned by different persons.

Given the treatment of stock purchase transactions under current law, if the proposed sale of Conrail stock occurred between private parties, the tax attributes of Conrail, such as its net operating loss carryforwards, investment tax credit carryforwards, and asset tax basis (including the so-called "frozen asset base"), would remain intact following the sale. The tax consequences of the proposed sale of Conrail to Norfolk Southern would depart from this private transaction model in that certain of Conrail's tax attributes would not survive the sale transaction. Thus, pursuant to a closing agreement to be entered into between Conrail and the IRS, as reflected in paragraph 4 of the Memorandum of Intent, Conrail's net operating loss, investment tax credit, and other carryforwards would, with certain exceptions, not carry over to taxable years beginning

after the date of sale (hereafter, the "Closing").* At the same time, other Conrail tax attributes, in particular, Conrail's asset basis, would, as in a private party transaction, survive the Closing.

We believe the different treatment of Conrail's tax carryforwards on the one hand and its asset basis on the other is appropriate for a number of reasons. Conrail's existing carryforwards arose during the period of the Federal government's ownership and are for the most part attributable to the Federal government's investment in Conrail. The same is not true of Conrail's asset basis. Although the assets held by Conrail have changed substantially since its formation in 1976, data provided to us by the Department of Transportation indicate that the aggregate tax basis of its assets as of December 31, 1983 is roughly equal to what it was in 1976. Thus, the proposed transaction would return Conrail to the private sector with substantially the same asset basis as at the time the Federal government acquired it.**

We recognize, of course, that the purchase price in a sale transaction will reflect the extent to which advantageous tax attributes carry over in the acquisition. Where the Federal government is the seller, however, any gain in purchase price from a carry over of favorable tax attributes must be weighed against future revenue losses attributable to the purchaser's utilization of the tax attributes. This weighing is more difficult to the extent the purchaser's ability to use the attributes is uncertain. In this respect, the value of Conrail's carryforwards is inherently more speculative than the value of its asset basis, because the carryforwards would be of future value only to the extent that annual depreciation deductions generated by Conrail's asset basis had already been fully utilized. It would thus appear reasonable for the Federal government to require the termination of Conrail's carryforwards rather than speculate as to their value, while, in accord with the model of a private transaction, permitting Conrail to return to the private sector with its asset basis intact.

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* The closing agreement also would provide that Conrail's taxable year would terminate as of the Closing.

** If the effects of inflation are accounted for, Conrail's current asset basis is, of course, much less than at the time of its formation. Moreover, since the value of Conrail's assets today likely exceeds their value at the time of Conrail's formation, the built-in loss in Conrail's assets (i.e., the excess of their basis over value) is likely smaller today than it was at Conrail's formation.

It should also be noted that the treatment of Conrail's tax attributes in the proposed sale is similar to what was approved by Congress at the time of Conrail's formation. Legislation adopted in connection with Conrail's formation, now reflected in section 374(c) of the Internal Revenue Code (the "Code"), provided that the net operating loss carryforwards of Conrail's predecessors would not carry over to Conrail, whereas Conrail would inherit its predecessors' asset basis. The tax consequences of the proposed sale of Conrail to Norfolk Southern would generally conform to that legislative precedent.

Finally, the carry over of Conrail's asset basis should not cause a reduction in Federal income tax revenues collected from Conrail. Although Conrail is a taxable entity, it has not previously paid Federal income tax, nor would it in the foreseeable future given its substantial carryforwards and the high basis in its assets. Because Conrail's carryforwards would not survive the proposed sale to Norfolk Southern, the transaction would, if anything, accelerate the point at which Conrail would become a taxpaying corporation.

Utilization of Conrail Deductions By Norfolk Southern

While we believe that the carry over of Conrail's asset basis is appropriate, we recognize that the proposed sale transaction would reduce Federal income tax revenues if future deductions generated by Conrail's asset basis could be utilized to offset otherwise taxable income of Norfolk Southern. As an includible member in Norfolk Southern's consolidated return, tax losses of Conrail could currently offset taxable income of any other member of the consolidated group to the extent such losses were not limited under the separate return limitation year ("SRLY") and the built-in deduction rules of the consolidated return regulations. These rules, in general, prevent the utilization of an acquired corporation's pre-acquisition losses (including losses or deductions attributable to assets with tax basis in excess of fair market value, so-called "built-in deductions") against income of any other member of the acquiring group. It is conceivable that Norfolk Southern could seek to mitigate the effect of these restrictions through any of the following strategies: by satisfying the so-called *de minimis* exception to the SRLY and built-in deduction rules, by transferring assets to Conrail, the income from which would be absorbed by Conrail losses, by diverting income opportunities to Norfolk Southern, or by merging Conrail into Norfolk Southern (or an affiliated corporation) in a transaction in which Conrail's tax attributes would carry over.

The consolidated return regulations provide an exception to the SRLY and built-in deduction rules, if, on the acquisition date, the aggregate of the adjusted tax basis of all assets of Conrail (other than cash, marketable securities, and goodwill) do not exceed the fair market value of such assets by more than 15

percent. See Treas. Reg. § 1.1502-15(a)(4)(i)(b). A review of Conrail's tax data, provided to us by the Department of Transportation, suggests that Conrail would not satisfy this *de minimis* exception, since its aggregate tax basis appears to exceed $3 billion, and Norfolk Southern is paying only $1.2 billion for 85 percent of Conrail's common stock. The *de minimis* exception, however, is based on the fair market value of Conrail's assets, rather than the value of Conrail's stock. The cash price paid by Norfolk Southern for Conrail stock need not correspond to the value of Conrail's assets, since it would not reflect other costs incurred by Norfolk Southern as a result of the transaction or liabilities burdening the assets of Conrail. Therefore, since we do not have appraisals or other direct information concerning the fair market value of Conrail's assets, we cannot conclude with certainty that Conrail would fail to satisfy the *de minimis* exception.*

Norfolk Southern's ability to avoid the effects of the SRLY and built-in deduction rules either by transferring assets or income opportunities to Conrail or by merging Conrail into Norfolk Southern or an affiliate would be constrained by Norfolk Southern's contractual obligations, by practical business considerations, and by the provisions of the tax law. Paragraph 12(b)(iii) of the Memorandum of Intent appears to prohibit a merger of Conrail into Norfolk Southern (or an affiliated corporation) for at least five years after the Closing. In addition, it is questionable whether Norfolk Southern would transfer significant income producing assets to Conrail given that, as reflected in Paragraph 12(b) of the Memorandum of Intent, there would be significant restrictions on Norfolk Southern's ability to withdraw assets from Conrail. With regard to tax law limitations, a transfer of significant assets or income opportunities to Conrail or a merger of Conrail into Norfolk Southern (or an affiliated corporation) could subject future use of Conrail deductions to challenge under section 269 of the Code. See Treas. Reg. § 1.269-3(b)(1).

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* Paragraph 12(e) of the Memorandum of Intent provides that as a condition to Norfolk Southern buying Conrail from the Federal government, Norfolk Southern shall have received (at the Federal government's sole election) either a ruling or a warranty that amounts paid to employees of Conrail for services rendered after Closing in order to increase their post-Closing wages to industry standard and the costs paid or incurred for certain routing concessions which are otherwise ordinary and necessary business expenses shall not be treated as built-in deductions and can be deducted when accrued or paid. Although the SRLY and built-in deduction rules apply to amounts economically accrued but not yet deducted, the above expenses do not appear to constitute built-in deductions. Because of the condition that such expenses must otherwise be ordinary and necessary business expenses, the ruling or warranty required by the above condition does not warrant the deductibility of such amounts; only that such amounts are not built-in deductions.

Warranty of Asset Basis

As provided in Paragraph 6(e)(ii) of the Memorandum of Intent, the Federal government would warrant to Norfolk Southern that the asset basis reflected on Conrail's tax return for the year ending on the Closing would not be decreased as a result of an audit adjustment for a taxable year ending on or before the Closing. We believe this warranty is appropriate for a variety of reasons. Most importantly, the warranty protection extended to Norfolk Southern is consistent with the allocation of risks that could be expected in an analogous private party transaction. Conrail has not been audited since its formation and its tax basis in many assets would have to be traced to its predecessors. As a consequence, Norfolk Southern has no effective means of determining whether Conrail's asset basis is accurately reflected on its tax returns. In circumstances where the accuracy of the selling party's tax accounting cannot be established, it is reasonable to expect the seller to retain the risk of audit.

Consistent with the above warranty, Paragraph 6(e)(iii) and (iv) of the Memorandum of Intent requires the Federal government to warrant that the adjusted tax basis of Conrail's assets would not be reduced and no gain or loss or income would be recognized by Conrail or Norfolk Southern as a result of the sale of Conrail's stock to Norfolk Southern, except in the event Norfolk Southern makes, or is deemed to have made, an election under section 338 of the Code. If a section 338 election were made (or deemed made) by Norfolk Southern in connection with its purchase of the stock of Conrail, Conrail would be treated as if it sold all of its assets to itself in a liquidating sale, and the tax basis of its assets would be adjusted to an amount based upon the amount Norfolk Southern paid for Conrail's stock (grossed-up to reflect a purchase of 100 percent of Conrail's stock). The Memorandum of Intent further provides that, for purposes of the warranty, Norfolk Southern would not be deemed to make a section 338 election as a result of any asset acquisition provided that Norfolk Southern (and its affiliates) elect either to treat such assets acquired in accordance with regulations promulgated under section 338 or elect under conditions to be agreed upon that the basis of such assets would not exceed the transferor's basis in the assets immediately before the acquisition. This warranty was provided because, as of the date the Memorandum of Intent was signed, the regulations providing for a carryover basis to avoid a deemed election under section 338, contemplated by Congress in the Tax Reform Act of 1984, had not been issued.

It should be noted that the warranty protection that Norfolk Southern receives is not a guarantee that the IRS will not audit Conrail for pre-Closing years or that, if it does so, it will not be entitled to require a reduction in Conrail's asset basis.

Rather, in the event of an IRS audit and any reduction in basis, the warranty procedure contemplated in the Memorandum of Intent and enabling legislation entitles Conrail to sue in Federal court and to obtain a judgment that could be applied to offset any increase in tax liability attributable to the basis reduction. Although this procedure leaves Conrail economically protected from the risk of audit, it does not otherwise impair the ability of the IRS to conduct an audit of Conrail. Retention of the audit authority of the IRS with respect to Conrail's pre-Closing years could be significant to the extent substantive tax issues relating to those years have relevance to issues arising in other tax years of Conrail or to the administration of the Federal income tax system generally.

Change in Methods of Depreciation

The potential value of any built-in loss or built-in deductions attributable to Conrail's assets also depends on the period of time over which those assets would be depreciated. The warranty as to asset basis provided in Paragraph 6(e)(ii) of the Memorandum of Intent contains a condition that the depreciation of such assets should be determined without extraordinary departures from the methods of prior years. In general, since a depreciation method is considered a method of accounting, a taxpayer cannot change its method of depreciation with respect to a particular asset without first obtaining permission from the Commissioner of the IRS.* In this regard, Conrail and Norfolk Southern would be treated the same as any other taxpayer if, after the sale of Conrail, a change in depreciation method were requested.

Carry Over of Earnings and Profits

At present, Conrail may have a deficit earnings and profit account reflecting its substantial net losses over the period of

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* Section 203(c) of the Economic Recovery Tax Act of 1981 permitted taxpayers to change their method of depreciating railroad track without having such change treated as a change in method of accounting. It does not appear that this provision applies to a change in the method of depreciating railroad track initiated after 1981. Thus, Conrail should not be able to change its present method of depreciating its "frozen asset base" without securing the prior approval of the IRS.

its operation.* The Memorandum of Intent does not directly state whether the earnings and profits history of Conrail would carry over to post-Closing taxable years. Since earnings and profits ordinarily would carry over in a stock acquisition, the failure to state a contrary result suggests that Conrail's earnings and profits account would survive the transaction. Since earnings and profits are a measure of a corporation's income or loss, it would seem that Conrail's earnings and profits should be treated consistently with Conrail's net operating losses, and thus should not carry over to post-Closing years. We thus believe that a definitive sale agreement should clarify the treatment of Conrail's earnings and profits by providing that they not carry over in the sale transaction.

The value to Norfolk Southern of a carry over of Conrail's earnings and profits is uncertain. Earnings and profits determine the extent to which a corporation's distributions to its shareholders are dividends rather than a return of capital. Although a deficit earnings and profits account would permit a corporation to make nontaxable return of capital distributions to its shareholders,** Conrail will be a wholly-owned member of Norfolk Southern's consolidated group and thus its distributions will be nontaxable whether characterized as dividends or as a return of capital. We understand that Norfolk Southern itself has a substantial surplus in its earnings and profits, and thus any distributions by Norfolk Southern to its shareholders would be fully taxable dividends even if they were attributable to distributions from Conrail. Moreover, Norfolk Southern's surplus in earnings and profits would not be offset by any deficit of Conrail even if Conrail were to merge with Norfolk Southern. See section 381(c)(2) of the Code.

<u>Cancellation of Conrail Debt and Preferred Stock</u>

The Northeast Rail Service Act, which directed the Department of Transportation to devise a plan for the sale of Conrail, also directed that Conrail be sold essentially free of the Federal

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* We have not been provided any data on Conrail's earnings and profits. There may be uncertainty as to the exact amount because of the uncertain effects of prior law.

** A carry over of any Conrail deficit in earnings and profits could be disadvantageous to Norfolk Southern, because it would limit Conrail's ability to issue new preferred stock to outside interests. The market for such preferred stock is predominantly among corporations, for whom dividend distributions are ordinarily more advantageous than returns of capital.

government's existing debt or preferred stock interests. The apparent intent of the legislation was that Conrail be returned to the private sector with a sound capital structure. This intention is reflected in Paragraph 3 of the Memorandum of Intent, which provides that prior to the sale approximately $850 million of outstanding Conrail debt, including accrued interest thereon, and approximately $2.3 billion par value of Conrail preferred stock, including accrued and unpaid dividends thereon, held by the Federal government would be "cancelled or retired, and contributed to the capital of Conrail." In addition, under Paragraph 6(e)(i) of the Memorandum of Intent, the Federal government would warrant that Conrail will not recognize income on account of the cancellation of Conrail preferred stock or debt.

Under general tax law principles, reflected in section 61(a)(12) of the Code, a corporation may recognize income where it retires outstanding indebtedness at a cost that is less than the face amount of the indebtedness. This discharge of indebtedness principle recognizes that a taxpayer has an economic profit when it borrows money that it is not required to repay in full. Certain exceptions to the discharge of indebtedness principle are enumerated in section 108 of the Code, including that a corporation does not recognize income where a shareholder contributes indebtedness to the corporation's capital (provided that the shareholder's basis in the debt is not less than the face amount of the debt). This exception, stated in section 108(e)(6), effectively recognizes that any excess of the amount borrowed from a shareholder over the amount repaid might have been directly contributed to the corporation without causing the corporation to recognize income.

Under the substantive principles described above, Conrail would not recognize income from the cancellation of its debt if such cancellation were treated as a contribution to its capital by the Federal government. Although there is little authority addressing whether a shareholder's cancellation of corporate debt is a contribution to capital, characterization of the cancellation of Conrail's debt as a contribution to its capital would seem probable. The cancellation of Conrail's debt would be structured in this form, the cancellation was effectively directed by Congress, and the practical effect of the cancellation would simply be to enhance the value of Conrail common stock owned or controlled by the Federal government.*

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* The Federal government owns approximately 85 percent of the common stock of Conrail, with the remaining 15 percent being held by Conrail Equity Corporation ("CEC"), a subsidiary of Conrail (see discussion below under Transactions Involving Conrail's ESOP).

Even if the cancellation of Conrail's debt were not treated as a contribution to its capital by the Federal government, Conrail's carryforwards would remain available to offset any discharge of indebtedness income to Conrail for a pre-Closing year. Given the size of Conrail's carryforwards in comparison to the amount of its outstanding debt, the warranty that Conrail would not recognize discharge income offers additional protection to Conrail only to the extent such income might be recognized after the Closing, i.e., in a year in which the carryforwards would not be available to absorb the income. Although it may be conceivable that the debt cancellation and sale of Conrail could be recharacterized so as to cause Conrail to recognize discharge of indebtedness income after the Closing, any such income would as a practical matter be attributable to the period in which Conrail was owned by the Federal government. We thus believe it is consistent with the other tax consequences of the proposed sale that Conrail be held harmless from any tax liability arising from the cancellation of its indebtedness. A warranty providing for this result is additionally appropriate given that the cancellation is effectively directed by legislation.

The proposed sale agreement also warrants that Conrail will not recognize income from the cancellation of its outstanding preferred stock. Under general tax law principles, a corporation does not recognize income upon a reacquisition or cancellation of its own stock. Thus, absent a recharacterization of the transaction, Conrail should not recognize income from the cancellation of its preferred stock.

Although we are uncertain as to why this warranty was requested, it might conceivably be out of a concern that Conrail's preferred stock could be characterized for tax purposes as indebtedness, and thus that Conrail may recognize income from its cancellation. There is little authority indicating under what circumstances an investment denominated as preferred stock could be recharacterized as debt for tax purposes. We nevertheless view the possibility of such recharacterization in Conrail's circumstances as remote. Recharacterization of any substantial portion of Conrail's preferred stock as debt could push Conrail near or into insolvency.

Transactions Involving Conrail's ESOP

Approximately 15 percent of Conrail's common stock is beneficially owned by Conrail's employee stock ownership plan ("ESOP").* Paragraph 2 of the Memorandum of Intent provides that, at or prior to the Closing, Norfolk Southern or Conrail shall have made appropriate arrangements with respect to the employees of Conrail to accomplish the acquisition by Norfolk Southern of such employees' 15 percent beneficial interest in the common stock of Conrail. While we understand that separate negotiations between Norfolk Southern and Conrail's employees are still pending, Exhibit A to the Memorandum of Intent indicates that Norfolk Southern proposes to transfer $375 million in cash or Norfolk Southern common stock to Conrail's ESOP.**

To the extent that Norfolk Southern's transfer to Conrail's ESOP is in exchange for the ESOP's beneficial interest in Conrail's stock, such amounts would not be deductible contributions by Norfolk Southern, but rather costs incurred in acquiring Conrail's stock. On the other hand, to the extent that the amount of Norfolk Southern's transfer to Conrail's ESOP exceeds the value of the ESOP's beneficial interest in Conrail's stock, such amount could be a deductible contribution by Norfolk Southern, subject to the deduction timing rules of Code section 404 (including section 404(j)) and the continued qualification of Conrail's ESOP. The enabling legislation specifically provides that no inference is to be drawn from the provisions of that legislation regarding either the allocation of Norfolk Southern's $375 million transfer between the purchase of Conrail's stock and deductible contributions to the ESOP or the deductibility of any portion of such transfer by Norfolk Southern to Conrail's ESOP.

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* CEC, all of the common stock and approximately 50 percent of the preferred stock of which is owned by Conrail, currently owns approximately 15 percent of the common stock of Conrail. The other 50 percent of CEC's preferred stock is owned by Conrail's ESOP. Under existing agreements, Conrail's ESOP by 1991 would own 100 percent of CEC's preferred stock which would then be exchanged for the 15 percent of Conrail's common stock held by CEC.

** It should be noted that under Paragraph 12(b)(viii) of the Memorandum of Intent Norfolk Southern and Conrail are prohibited for at least five years from obtaining a reversion of any excess assets held in connection with Conrail's Supplemental Pension Plan. A reversion of plan assets to either Norfolk Southern or Conrail would not be permissible unless and until the plan is terminated and all liabilities of the plan to the employees are fully satisfied.

If the form of Norfolk Southern's arrangements with Conrail's employees were to cause disqualification of Conrail's ESOP, such employees generally would be currently taxable on the value of their beneficial interest in the trust. In this regard, section 132 of the enabling legislation provides that Conrail's ESOP and related trusts maintained, amended, or adopted in implementing the Secretary of Transportation's plan for the sale of Conrail shall be deemed to meet the qualification requirements of sections 401 and 501, notwithstanding that such plans may not meet the requirements of Code section 415 (which relate to limitations on contributions and other additions with respect to participants in a qualified plan) or that participants in such plans may be entitled to withdraw a portion of the shares allocated to their accounts prior to the expiration of the two-year period generally imposed by the IRS for qualified plans (see Treas. Reg. § 1.401-1(b)(1)(ii)). Although Norfolk Southern's arrangements with Conrail's employees have not been finalized, we believe it appropriate, given the possibly unique form of such arrangements and the unusual structure of Conrail's ESOP, to waive by legislation these two possible technical violations in order that Conrail's ESOP would maintain its qualification.

Separation of Government Roles

The IRS is charged with administration and enforcement of the Federal income tax laws. In order to carry out this mission effectively, no preference or special rules can be adopted for any taxpayer.

We believe the Department of Transportation's plan for the sale of Conrail is consistent with the special responsibilities of the IRS as administrator of the Federal income tax laws. Most importantly, the plan does not restrict the IRS from auditing or assessing tax liabilities against Norfolk Southern or Conrail after the sale. To the extent Norfolk Southern would be protected in the proposed transaction against possible tax liabilities of Conrail or of Norfolk Southern, such protection would be provided in the form of a warranty, rather than covenant by the IRS, in order that the IRS be able to fulfill its mission of evenly administering and enforcing the Federal income tax laws. Certain legislation, which is included in the proposal submitted by the Department of Transportation, would be necessary to implement a procedure for Norfolk Southern to enforce such tax warranties against the Federal government.

* * *

This concludes my prepared remarks. I would be happy to respond to your questions.

TREASURY NEWS

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STATEMENT OF THE HONORABLE JOHN M. WALKER, JR.
ASSISTANT SECRETARY (ENFORCEMENT AND OPERATIONS)
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON CRIME
COMMITTEE ON THE JUDICIARY
U.S. HOUSE OF REPRESENTATIVES
APRIL 16, 1985

Progress in the Fight Against Money Laundering

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear before you today to discuss the problem of money laundering. As this Committee is fully aware, money laundering is a serious challenge to law enforcement and a clear danger to the soundness and integrity of our financial system. In my testimony today, I will discuss the scope of the money laundering problem and some of the reasons why it is so pervasive. I will explain why Treasury believes that an attack on money laundering is essential to a successful fight against organized crime and drug trafficking. I will then summarize the progress we have made and discuss initiatives with the potential to further our progress.

The Treasury Department sincerely welcomes the interest that you, Chairman Hughes, and this committee have expressed in this critical topic, and we look forward to assisting you as you consider possible legislative measures to enhance our country's efforts against money laundering and other organized crime.

Why Money Laundering Poses a Difficult Challenge to Law Enforcement

Mr. Chairman, for a number of reasons, money laundering is a major challenge for law enforcement. First, the scope of the problem is staggering. While no one knows with certainty how much money is laundered in the United States every year, estimates point to anywhere between $50 and $65 billion in laundered crime proceeds from drug trafficking alone. From money laundering cases Treasury has investigated, we know that a single money laundering enterprise can wash $300 million or more in crime proceeds in less than a year's time.

Suppressing money laundering is enormously difficult for another reason: there are seemingly infinite ways for criminals to accomplish it. Treasury's investigators have uncovered money laundering schemes that are as varied as the human imagination will allow. They can be conducted domestically or internationally, and they can exploit various types of financial institutions. Because all organized crime depends on skilled money launderers for its very existence, there is a continuous incentive for criminals to develop new methods for circumventing Federal reporting requirements and for concealing cash and pools of assets from the eyes of law enforcement.

Money laundering has seen unprecedented growth over the last decade for another basic reason: it is an extremely lucrative criminal enterprise. Treasury's investigations have uncovered members of an emerging criminal class: They are the professional money launderers who aid and abet other criminals through financial activities. These individuals do not fit the stereotype of an underworld criminal. They are accountants, attorneys, money brokers, and members of other legitimate professions. They need not become involved with the underlying criminal activity except to conceal and transfer the proceeds that result from it. They are drawn to their illicit activity for the same reason that drug trafficking attracts new criminals to replace those who are convicted and imprisoned; and that reason is greed. Money laundering, for them, is an easy route to almost limitless wealth.

Our free society and our diverse economy, with its ready access to international financial networks, provide the setting for the money launderer's operations. We must recognize that while our law enforcement tools--chiefly the Bank Secrecy Act--allow us the means to obtain reporting that can disclose suspicious transactions, there are limitations on the amount and type of information that law enforcement may obtain. Later in my testimony, I will describe how Treasury is seeking to overcome some of these limitations. I will also address the subject of possible legislative changes that have the potential to strengthen the tools at law enforcement's disposal for use against the money laundering problem.

An Attack on Money Laundering is Essential to the Fight Against Organized Crime and Drug Trafficking

Mr. Chairman, the difficulties I have mentioned should not cause anyone to believe that our fight against money laundering is a hopeless one. Quite to the contrary: in the past four years, we have recorded substantial and remarkable progress. I will give some examples of this progress in a moment. But for now, let me stress a principle that our financial investigations have demonstrated time and time again: that we can never hope to control drug trafficking and other forms of organized crime in our society unless we continue our efforts to go after the money that is at the heart of every criminal enterprise. The reasons behind this conclusion are fundamental ones.

Money, of course, is the motivation behind every organized crime transaction and the thread that ties together the components of a criminal enterprise. If we can trace the money, the trail will often lead to high-level criminals. The leaders in any criminal enterprise usually take great pains to distance themselves from the illegal source of their income. But they can usually be found close to the money.

The money, if seized, is potentially devastating evidence at a criminal trial. A jury can get lost in the technical details of a white collar crime. But if jurors can be shown the illicit proceeds, they can more readily understand the full impact of the crime.

Also, through seizure and forfeiture, we can deprive a criminal enterprise of its lifeblood. For instance, drugs can be readily replaced by a drug trafficking organization, but its cash reserves are essential to its functioning. It is this cash that finances new drug importing ventures, and is the means of corrupting justice. Large monetary seizures can cripple the organization and possibly put it out of business altogether.

Finally, the Bank Secrecy Act is itself the authority for criminal and civil penalties. As an independent basis for prosecution, it can be the statutory weapon that breaks up a criminal enterprise and imprisons its members.

Treasury's investigative successes under the Bank Secrecy Act demonstrate the validity of this approach. In 1980, Treasury, with the support of the Justice Department, organized Operation Greenback in Miami to conduct financial investigations using the reporting information provided by the Bank Secrecy Act. The Treasury task forces modeled after Greenback now total forty in number, located in cities across the nation.

Since 1980:

- They have produced over 1300 indictments and over 460 convictions;
- They have resulted in $81.8 million in currency seizures and $34.3 million in property seizures; and
- They have destroyed eighteen major money laundering enterprises, which laundered a documented total of $2.8 billion. (Chart on Money Laundering)

Greenback itself has become a component in one of the President's Organized Crime Drug Enforcement Task Forces, which now number thirteen. These Task Forces have initiated over 880 cases, even though they have been fully operational for only 21 months. They have produced indictments of more than 4600 individuals and have resulted in more than 1,860 convictions. Two out of three Task Force cases have a financial component.

Treasury has contributed approximately 480 special agents to work full-time on the OCDE Task Forces, 400 of which are IRS and Customs agents who are investigating money laundering. The other 80 agents are ATF agents who are investigating the firearms violators who participate in and support the drug trade and organized crime.

Our Attack on Money Laundering Requires the Full Participation and Cooperation of the Financial Community

Mr. Chairman, while Treasury's financial investigations have made considerable progress, it is no secret that money laundering remains an enormous challenge.

When the Bank Secrecy Act was passed, Congress contemplated that it would strengthen law enforcement's ability to combat white collar and organized crime. Over the fifteen years since enactment of this landmark legislation, there is no question that the Act has succeeded in this regard. But as a society, it is essential that we set a higher goal: if we are to strike a telling blow against drugs and crime, we must go further, and strive to deny criminals access to our financial system.

This, of course, is a task that law enforcement cannot accomplish alone. Banks and other financial institutions must do more to ensure that their employees do not become, wittingly or unwittingly, the prey of the criminal operative with cash to launder.

Certainly, full compliance with the reporting requirements is essential. Treasury depends on the reporting data generated by these requirements for its own financial investigations and the analytical support it provides other law enforcement agencies.

The Treasury Financial Law Enforcement Center, or TFLEC, combines these data with other sources of intelligence to generate financial intelligence reports, currency flow charts, and link analyses, which probe the financial connections inside and among illicit enterprises. TFLEC provides vital support to ongoing investigations, including those of the OCDE and Treasury Task Forces, and it generates leads for the development of new cases.

It is fair to say that were it not for the reporting information Treasury receives as a result of the Bank Secrecy Act, the major money laundering enterprises I mentioned earlier would all be thriving today. To ensure the availability of reports, we must continue to improve the level of compliance by financial institutions. Recent cases involving banks that have violated the reporting requirements illustrate that there are instances in which currency transaction reports and currency and monetary instrument reports are not being filed. We have also seen misuse of the exempt lists, under which specified bank customers may make cash deposits without the filing of CTR's.

We have begun a number of initiatives to effect further improvements in compliance:

- We are working with the bank regulatory agencies to improve the application of the examination procedures;

- We have worked with the President's Commission on Organized Crime, which has developed a series of regulatory, administrative, and legislative recommendations. Some of the regulatory and administrative recommendations have already been implemented, and the remaining ones are under serious consideration.

- We are giving assistance to banking industry associations to foster the development of improved training for bank employees. Regarding the banking industry, there is a further point I would like to make: we must not confine our thinking to the bank's legal obligations. Every financial institution has a moral and ethical obligation not to be used to further criminal activity. This obligation extends both to the community served by the bank and to our financial system as a whole. For it is certain that when criminal operatives can use a financial institution at will for their own purposes, the overall trust in our banking system is eroded. Thus banks must be vigilant to spot instances of money laundering and must report suspicious transactions to the law enforcement authorities.

The Growing Problem of Offshore Money Laundering

Mr. Chairman, I would like to turn to another aspect of the problem facing us: offshore money laundering. Even as we improve compliance with the Bank Secrecy Act, we must recognize that the expanded Federal enforcement effort will cause a shift to offshore money laundering. The *Milian-Rodriguez* case, in 1983, exemplified this trend, and involved the international transportation of over $300 million in cash to offshore accounts.

Our government has responded to this trend by seeking international agreements providing for access to evidence relevant to U.S. criminal investigations. On July 26, 1984, Great Britain and the United States exchanged diplomatic correspondence establishing our access to documentary information located in the Cayman Islands that is material to investigations related to drug trafficking. The agreement became effective on August 29, 1984, and since that time has resulted in the obtaining of valuable information for prosecutions in the United States.

The Departments of Justice and Treasury have been seeking a similar agreement with the Republic of Panama and will resume negotiations with Panamanian officials later this month.

In further response to the trend of offshore money laundering, Treasury published proposed regulations last year that would establish procedures under which the Secretary could require specified U.S. banks to report financial transactions with foreign financial institutions. These regulations, which will be promulgated in final form in the near future, will provide a mechanism to help identify money transfers related to drug trafficking or other organized crime that occur between U.S. and foreign financial institutions.

In exercising the authority under this regulation, Treasury will select classes of transactions with foreign financial institutions as the subject of reporting on the basis of available information indicating unusual financial activity. Treasury will strive to impose reporting requirements in the least burdensome manner consistent with our need for the information. The Act is quite specific in requiring that Treasury carefully consider how its international transaction reporting requirements affect financial institutions.

Initiatives to Strengthen Our Attack on Money Laundering

Mr. Chairman, as I mentioned earlier, the President's Commission on Organized Crime has developed legislative recommendations as well as suggested regulatory changes and improvements for the administration of the Bank Secrecy Act. Some of these legislative recommendations have been incorporated in various bills now pending before the Congress, and I would be remiss if I did not express my appreciation for the efforts that you, Chairman Hughes, have put forth to develop and introduce legislation to combat money laundering. I would also like to express my appreciation to Congressman McCollum, for his leadership and initiative in this area.

With regard to the entire body of proposed legislation now pending before both houses of Congress, I would like to offer a few observations. First, an area of legislative inquiry that we consider worthy of close examination is the Right to Financial Privacy Act. While Treasury recognizes the rationale for preserving the confidentiality of banking records, we strongly suggest that the Congress re-examine the current balance between the maintaining of this confidentiality and the legitimate interest of law enforcement in receiving usable information concerning potential violations.

Another topic that certainly deserves examination is the matter of an administrative summons power that Treasury could use in ensuring compliance with Title 31. Administrative summons authority is quite common among Federal agencies, yet Treasury lacks any such authority that could be applied to determine whether a financial institution is complying with applicable Title 31 reporting requirements. This authority would be of great benefit to Treasury in fulfilling its civil enforcement responsibility and its oversight responsibility regarding bank regulatory agencies.

Mr, Chairman, this concludes my formal statement. I would be pleased to answer any questions that you and other members of the Committee may have.

Attachment

Attachment

SIGNIFICANT MONEY LAUNDERING CASES

Convicted	Dollars Laundered	Time Frame
Isaac Kattan	$500,000,000	36 months
Beno Ghitis	268,000,000	5 months
Orozco	145,000,000	13 months
Armenteros et.al.	130,000,000	36 months
Great American Bank	95,000,000	13 months
Zapata et.al.	17,000,000	8 months
Pinto	12,000,000	13 months
Subtotal	$1,167,000,000	

Pending	Dollars Laundered	Time Frame
A	$300,000,000	24 months
B	300,000,000	36 months
C	250,000,000	20 months
D	230,000,000	36 months
E	180,000,000	24 months
F	140,000,000	8 months
G	70,000,000	8 months
H	65,000,000	12 months
I	60,000,000	12 months
J	20,000,000	18 months
K	9,000,000	3 months
Subtotal	$1,624,000,000	
Total	$2,791,000,000	

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STATEMENT OF THE HONORABLE
JAMES W. CONROW
DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
BEFORE THE
HOUSE SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

APRIL 18, 1985

Mr. Chairman and Members of the Subcommittee:

The Administration is seriously concerned by the extremely difficult development problems confronting the countries of Sub-Saharan Africa. We attach major importance to an effective United States development role in the region. I therefore welcome the increased attention being focused on Sub-Saharan Africa by the Subcommittee, reflected in the Chairman's proposed bill, H.R. 1949, as well as the opportunity you have provided for me to meet with you to discuss our shared goal of strengthening the ability of our bilateral and multilateral programs to promote sustainable economic growth in the countries of the region.

Overview:

A general consensus has emerged that policy reform is the key to long-term progress in Sub-Saharan Africa. There is also widespread recognition that improving the quality of external assistance is as important as the volume. We also want a program which maximizes its impact on Africa yet realistically recognizes the limitations posed by the region's relatively new institutions, limited technical manpower, and overall absorptive capacity. These have been paramount considerations in formulating an effective U.S. response to Africa's development needs. The result of these considerations is a very substantial U.S. effort comprised of an expanding bilateral program, a concerted effort in the World Bank to focus IDA and IFC resources on Sub-Saharan Africa, and growing support for the African Development Bank and Fund.

Economic Situation:

Approximately 400 million people live in the 45 countries of Sub-Saharan Africa. While the current tragedy of widespread famine and drought has attracted worldwide concern and renewed interest in the region, Sub-Saharan Africa's problems are not a sudden development. Rather, they are the result of a process of economic deterioration which began in the late 1960s. A number of inter-related factors have contributed to Africa's economic decline. However, the roots of the current problem are largely based on past policies -- such as inappropriate investments, misaligned exchange rates, and skewed product pricing. These have compounded existing structural deficiencies, discouraged efficient use of resources, and significantly reduced the productivity of investment.

There is still great diversity among the economic situations of individual African countries. In general, however, the region's overall situation in recent years has been characterized by declining per capita agricultural output, a high level of idle industrial capacity, a deteriorating physical infrastructure, and inefficient institutions. Sub-Saharan Africa's external position has also weakened significantly -- in part due to the international economic environment -- with declines in both export volumes and overall terms of trade, and a major build-up of external indebtedness.

Nonetheless, favorable developments in a number of countries have taken place over the past year. A return to more normal rainfall patterns in several key areas appears to be taking place, with an immediate, positive impact on agricultural production. Significant policy-reform programs are under way in a growing number of countries, and prospects are promising for real GDP growth in 1985 for the first time in four years.

World Bank Sub-Saharan Africa Report:

As a result of its extensive experience in Africa, the World Bank has accumulated an impressive and internationally respected store of development expertise on the region. In August 1984, the Bank issued its third report on Sub-Saharan Africa analyzing development prospects and outlining an action program to help restore economic recovery. In our view, this report was a frank and objective analysis. The key themes in the report are the urgent need for policy reform and getting better value from both internal and external resources.

With respect to domestic policy environment, the report criticizes continued policy distortions, places major stress on market incentives -- particularly in agriculture and including realistic exchange rates -- and identifies the need for major public sector reforms, reductions in public expenditure, and institutional reform geared to better coordinated and more efficient management. Africa's population growth, the world's highest, as well as environmental destruction and the lack of human infrastructure are also highlighted.

With regard to external assistance, the key emphasis is on improving the quality of donor support for African countries implementing major policy reform. The need for better aid coordination to improve project selection and more emphasis on the rehabilitation and maintenance of existing facilities -- rather than new infrastructure -- is also stressed. In addition, the report outlines a program to increase the effectiveness of the Bank's own assistance efforts in Africa.

U.S. Views:

The Administration agrees that policy reform is the key to sustained economic progress in Sub-Saharan Africa. We also recognize the importance of adequate donor support for those countries implementing such reform. In this context, we are working hard to increase the effectiveness of both our bilateral and multilateral assistance efforts. At the same time, the difficulties of putting together effective projects in Africa should not be underestimated. There are major absorptive capacity constraints, with the weaknesses in the region's institutional infrastructure providing a particularly difficult obstacle to effective project implementation.

Bilateral Program:

The United States has a very considerable and expanding bilateral assistance program for Sub-Saharan Africa, including food aid, project specific assistance, and non-project support funds. Total U.S. bilateral assistance to Sub-Saharan Africa rose from $708 million in FY 1980 to $843 million in FY 1983. It is projected to total over $1.8 billion in FY 1985; more than $1.0 billion in commitments of food aid and $789 million in assistance excluding food.

The main objectives of our bilateral assistance strategy are economic stabilization, increased agricultural production, and human resources development. To achieve these objectives, our bilateral programs are supporting economic policy reforms to create incentives for growth and to enable the indigenous private sector to play a more dynamic role while helping to develop the technologies and institutions required for sustained growth.

The African Development Bank and Fund:

On Tuesday, I discussed with you the Administration's support for the efforts of the African Development Bank and Fund to play more important roles in addressing the fundamental problems facing Africa. In the FY 1980-84 period, lending commitments from the Bank and Fund totaled $3.7 billion.

The proposed U.S. contribution for the Fourth Replenishment of the AFDF is $225 million, an increase of 50 percent over the previous U.S. commitment level. The United States is the largest contributor to the replenishment, and our 15.4 percent share is an increase over the previous replenishment's 13.1 percent share.

The market related lending of the AFDB goes to the relatively higher income countries of Africa for public utility, transport and agricultural projects. The Bank has begun work on formulating its operational plan for the 1987-91 period. We intend to help the AFDB fashion a plan to guide the institution into the next decade while strengthening its financial and technical capacity.

World Bank Operations:

The operations of the World Bank are specifically designed to encourage appropriate policies and thereby assist in the economic growth of its developing country members. The Bank has significantly expanded its operations in Africa and, in addition to its proven expertise as an investment project lender, provides helpful policy guidance and technical assistance, and acts as a catalyst in encouraging private enterprise and investment capital.

In the FY 1980-84 period, IBRD commitments to African countries totaled $4.1 billion. Given the near-market terms of IBRD loans, this assistance has concentrated on the relatively higher-income countries; with Nigeria, the Ivory Coast and Kenya accounting for about two-thirds of the total. Over the same five-year period, concessional IDA commitments to Africa totaled $5.2 billion with the five largest recipients (Sudan, Uganda, Kenya, Tanzania, and Zaire) accounting for almost 40 percent of the total. In addition to IBRD/IDA commitments, gross IFC investments totaled $417 million over the FY 1980-84 period.

The United States remains the largest single contributor to the World Bank, and we are working with Management and other members to improve the effectiveness of the Bank's assistance efforts in Africa. In this context, we are pleased at the speed with which the Bank has recently moved, with the full support of the Executive Board, to strengthen the administration and management of its African operations with the objective of supporting policy reform efforts in the region.

While we want the Bank to continue emphasizing its mandated responsibility for solid investment project lending, the United States has also supported Bank efforts to respond effectively to the changing circumstances and the economic realities of individual members. The Structural Adjustment Lending (SAL) program is a good example of such flexibility and has proved a valuable instrument of fast disbursing support for countries willing to formulate and implement programs of structural adjustment. Since their introduction in FY 1980, there have been 10 SALs (totaling $841.6 million) to six African countries. We also support sector adjustment loans as appropriate instruments for encouraging adjustment as long as there is effective conditionality. Such sector adjustment loans may be particularly appropriate for Sub-Saharan Africa when institutional weaknesses hinder the design and implementation of more comprehensive policy based lending or when macro-policies are generally adequate.

Concessional IDA resources are of particular importance to Africa. In the international negotiations which preceeded agreement on the Seventh Replenishment, the United States took a leadership role in urging that on the basis of need, lack of alternative financing, and limited opportunities for improving terms of trade, Sub-Saharan Africa should have first claim on available resources to the extent that they can be used effectively. While the share of annual IDA lending going to Africa has increased significantly -- from about 26 percent in FY 1980-81 to 34 percent in FY 1982-84 -- we view the 35 percent share of IDA VII currently programmed for Sub-Saharan Africa as still too modest and not fully responsive to the IDA Deputies' recommendation to accord "highest priority" to this region.

Within the last year, a new five-year program has been designed for the IFC. The United States took an active role in the construction of this plan, and successfully encouraged agreement to allocate a larger share of IFC's resources to Sub-Saharan Africa with an approach that reflects the economic circumstances of the region, i.e., a focus on promotional activities and smaller scale projects. Twenty-four percent of IFC projects in the new program will go to Sub-Saharan Africa. The United States and other member countries support an increased and even accelerated IFC investment program because of the firm belief that a strengthened private sector is a sine qua non to sustained, balanced economic development.

World Bank Special Facility for Sub-Saharan Africa:

In January, 14 governments and the World Bank agreed to establish a Special Facility for Sub-Saharan Africa. This Facility will finance fast disbursing assistance including structural adjustment, sector policy reform, and rehabilitation in countries committed to monitorable stabilization and adjustment programs. The emphasis placed on encouraging policy reform is consistent with the policy based thrust we support for the Bank's other operations.

In our view, donors must have the flexibility to respond to Africa's needs in ways of their own choosing. Such responses should of course be coordinated with the World Bank and other donors in order to ensure resources are being utilized in the most effective and rational manner. Thus rather than participating in the Special Facility, we preferred instead to concentrate on improving the impact of our bilateral program and enhancing the effective use of existing multilateral resources. Given the substantial effort we are already making, we do not believe U.S. participation in the Special Facility as provided for in H.R. 1949 is warranted. However, the Administration fully supports the Special Facility's objectives which are very similar to that of AID's targeted assistance for selected African countries pursuing reform.

Conclusion:

We view the U.S. response to the current difficulties of Sub-Saharan Africa as constructive and forthcoming. In the final analysis, the pursuit of appropriate domestic policies by individual countries will be the key element in reversing the alarming economic trends in Africa and restoring sustained growth. For those committed to do so, we remain ready to lend our support and will work hard to increase the effectiveness of our very considerable bilateral and multilateral assistance.

Thank you, Mr. Chairman.

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April 18, 1985

RICHARD G. DARMAN
DEPUTY SECRETARY OF THE TREASURY

Richard G. Darman was confirmed as Deputy Secretary of the Treasury on January 31, 1985.

From 1981 to 1985, Mr. Darman served as Assistant to the President of the United States and Deputy to the Chief of Staff.

Prior to joining the White House staff, Mr. Darman was a member of the faculty of Harvard's Graduate School of Government and a partner in ICF Incorporated, a management and economic consulting company. He served previously in government from 1970 to 1977, in policy positions in 5 Cabinet Departments (HEW, Defense, Justice, Commerce and State). His prior service included service as Assistant Secretary of Commerce for Policy, a position for which he was nominated by President Ford and confirmed by the Senate.

Mr. Darman, 41, is an honors graduate of Harvard College and Harvard Business School. He is married to Kathleen Emmet (Darman), Ph.D. They have two sons, and reside in Virginia.

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For Immediate Release
April 18, 1985

Contact: Bob Levine
Phone: (202) 566-2041

U.S. and Saudi Arabia to Hold Joint Economic Meetings

Secretary of the Treasury James A. Baker, III will host the Ninth Session of the United States - Saudi Arabian Joint Economic Commission on April 22-23, 1985. The Commission, established in 1974, is co-chaired by Secretary Baker and Saudi Minister of Finance and National Economy, Mohammed Abalkhail.

The two day series of meetings will be held at the Treasury Department. The participants will review the ongoing Joint Commission technical cooperation projects, which include joint activities in such fields as transportation planning and development, supply management, and a cooperative arrangement with Faisal University involving five leading U.S. universities. To date, there are 21 ongoing and five complete Joint Commission projects.

At 9 a.m. Monday, April 22nd, at the start of the Joint Commission meeting, there will be a five-minute photo opportunity in the Cash Room of the Main Treasury Building.

Concurrently with the Joint Commission Session, the U.S. - Saudi Arabian Businessmen's Dialogue will also meet. The Dialogue, a forum for representatives of the Saudi and American business communities to discuss issues of mutual interest, is co-chaired by Mr. T. A. Wilson, Chairman and Chief Executive Officer of the Boeing Company and Mr. Suliman S. Olayan, Chairman of the Olayan Group.

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TREASURY NEWS

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Oral Statement by
The Honorable James A. Baker, III
Secretary of the Treasury of the United States
Concerning a Blueprint for Global Growth
Before the Development Committee
Washington, DC
April 18-19, 1985

Chairman Khan, President Clausen, Managing Director de Larosiere, and Fellow Governors:

It is a distinct pleasure for me to sit with you as a member of this Committee. I believe that these special meetings of the Interim and Development Committees provide a unique opportunity for all members of the World Bank and International Monetary Fund to discuss, in a frank and open manner, issues of concern to all of us.

Mr. Chairman, your personal contribution in arranging these meetings has been most welcome and you have our continued respect and gratitude for your strong leadership. We also thank the staffs of the Bank and the Fund for the excellent analysis which will facilitate our discussions.

Six months ago, my predecessor joined with you in calling for these special sessions in order that we might examine in a comprehensive way the policy approach necessary to move toward a sustained pattern of global growth. In yesterday's meetings we discussed the progress that

has been made to reduce external imbalances and to improve growth prospects in the world economy in the second half of the 1980s.

We recognize the important gains already realized and the necessity for undertaking efforts to assure continued progress toward sustained global growth. We began to develop a blueprint for global growth in the next few years.

Today we will examine a range of policy issues that will determine the prospects for growth and development over the longer term. We will, I hope, work to complete our blueprint in order to ensure that our actions are part of a long-term strategy for sustained growth. I will not dwell on these individual issues in my opening statement today. I am submitting detailed comments for the record.

In reviewing our economic progress, we should all recognize that it has entailed extraordinary acts of courage among nations, both singularly and collectively. Significant economic adjustment, some of it painful, has taken place. But our work is not yet finished.

Many countries still face fundamental problems. Despite expanding world trade, debt service obligations in many cases are high in relation to export incomes. We can all agree that adjustment efforts must be continued. In addition, the environment for trade and investment flows must be liberalized.

Our experience since 1982 indicates that we are on the correct path. We firmly believe that sustained and widely shared growth is possible. But we also recognize that together we will continue to face some difficult choices as we implement our policy blueprint. The need for mutual understanding will certainly increase.

In calling for these special sessions, the United States emphasized a desire for informality which would permit true dialogue--a full and frank exchange of views. We spoke not of negotiation, but of the need to achieve understanding. And we remain fully committed to achieving those objectives today.

These talks should not be a debate between industrial and developing countries. They require that all participants help to identify policies that will encourage new global growth and development. In this vein, I would hope that those developing countries among us who have identified and implemented successful policy approaches would share the benefit of their experience with others.

I look forward to working with each of you to identify fresh approaches to the issues and the problems we face. My hope is that at the end of our discussions, we will have reached a new level of understanding and a renewed determination to work together toward a global environment which provides the basis for sustained growth and future prosperity for all nations.

Thank you, Mr. Chairman

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STATEMENT OF THE HONORABLE JAMES A. BAKER
SECRETARY OF THE TREASURY
OF THE UNITED STATES
CONCERNING
A BLUEPRINT FOR GLOBAL GROWTH

BEFORE THE
MEETINGS OF THE
INTERIM COMMITTEE OF THE INTERNATIONAL MONETARY FUND (IMF)
AND DEVELOPMENT COMMITTEE OF THE WORLD BANK AND THE IMF

APRIL 17-19, 1985
WASHINGTON, D.C.

I welcome the opportunity to participate in these special meetings of the Interim and Development Committees. The United States proposed these meetings last fall to permit a frank and informal dialogue on the prospects and policies for growth, adjustment, and development over the medium term.

I am convinced that an informal dialogue is precisely what we need to understand better how each of us can contribute to achieving stronger and more balanced global growth. We all want growth for our economies -- not stop-go spurts of recession and growth punctuated by periods of high inflation, but sustained growth. Jobs we can count on. Markets we can depend on. Creditworthiness that can be maintained so that credit will be there when it is needed.

Those are not such impossible goals. But they are ones that require considerable thought and medium-term planning, rather than just looking at the problems of the moment. And that's what these meetings are designed to do:

To give us a chance to talk -- frankly and off the record -- about the important progress achieved in recent years in the face of very difficult problems.

More importantly, to give each of us an opportunity to listen to one another, and thereby to improve our understanding of the underlying economic situation in our economies, as well as our fundamental dependence on each other.

To review the outlook for the rest of the 1980s and to consider together what policies might improve the prospects for sustained, low inflation growth.

And to help build a consensus on what each of us can and will contribute to that common objective.

Our task, in sum, is to develop a "blueprint" of policies for global growth, to which each of us can contribute and from which all of us will benefit. This does not mean identical policies in all countries. Our economies vary immensely, have different needs, and can draw on unique strengths. But we all can and must play a role in following policies that will promote growth.

Considerable progress has already been made in restoring growth, reducing inflation, allowing markets a greater role in our economies, and addressing international debt problems. Yet much still remains to be done to assure sustainable, non-inflationary growth and job creation over the medium term.

Our job now is to assess the progress that we've made and to determine how to direct our efforts to consolidate and build on that progress.

Recent Progress

The industrial economies are in their strongest position in many years. This progress derives, in large part, from our success in dealing with inflation. The widely accepted view of the late 1970's was that industrial country inflation rates near the double-digit range were the best that could be expected. But over the past four years, we have fundamentally altered our inflation performance and outlook. The average inflation rate in the industrial countries in 1984 was 5.1 percent, the lowest since 1972, immediately preceding the first oil shock.

Inflation rates have stayed at low levels during the recovery, and can stay low as long as we continue to pursue sound and stable monetary and fiscal policies. This could be the only period since the early sixties when inflation rates four years into a recovery are lower than at the beginning of the recovery!

In addition to these inflation gains, the recovery in our economies has solidified. Last year's average growth in the industrial countries was the strongest since 1976. Strong U.S. growth has led the way, accounting for nearly one half of the real economic growth of the major European countries since 1982, with a 32 percent increase in European exports to the United States last year. In addition, the disparities in growth among our countries are narrowing significantly. In 1983-84, the average annual rate of U.S. real GNP growth of 5.3 percent was more than three times the rate of European growth. In 1985-86, it is projected that this differential will narrow to less than 1 percent as U.S. growth declines to a more sustainable 4 percent range and European recovery moves the growth rate there above 3 percent.

This low inflation recovery in the industrial countries has given a substantial boost to growth and adjustment in the developing countries. U.S. expansion alone since 1982 has directly increased non-oil LDC exports by $25 billion, accounting for more than half of the total growth in LDC exports during that period.

But, as important as industrial country growth has been for the LDCs, the recovery that has begun to broaden among developing countries is critically dependent on their own policies. Through the use of a range of policies, particularly sound monetary, fiscal, and exchange rate policies, a number of developing countries have been able to take advantage of the expanding world economy to restore growth, slow inflation and reduce sharply their balance of payments deficits.

Real economic growth rates in the LDCs have, in fact, been better than many had anticipated. Few expected, for example, the non-oil LDCs to grow at 4.5 percent last year. In addition, just as in the industrial world, growth is becoming increasingly more balanced geographically among developing countries, an important development in the medium-term outlook.

One must be generally impressed by the substantial improvement in the aggregate current account deficit of the indebted LDCs, from $113 billion in 1981 to $38 billion last year. The turnaround in the position of the "market borrowers" category from a peak deficit in 1982 of $74 billion to only $8 billion last year was striking. These adjustments reflect the progress that has been made generally in dealing with debt problems during the last few years. Adjustment in these countries was particularly welcome and necessary in light of the need to reestablish their access to private credit.

Some countries clearly still have a way to go in reducing current account deficits. However, the indebted developing countries' aggregate current account position is approaching a level which should be sustainable over the medium-term, depending, of course, on policy implementation in individual developing countries, as well as policies and performance in the industrial world.

For many developing countries, the initial phases of adjustment should be over. This is reflected not only in the resumption of real economic activity but also by the fact that last year non-oil LDC exports rose by 12 percent, while their imports rose by nearly 6 percent. Indeed, external adjustment now seems sufficiently advanced in some cases to permit further adjustment efforts in many countries to be directed increasingly toward improving domestic savings and investment, along with continued implementation of those policies which have enabled the adjustment in the external sector to be achieved.

Medium-Term Prospects and Policies

The papers and medium-term scenario developed for us suggest that we can build on the progress achieved to ensure a bright future if all countries, developing and industrial alike, make serious, determined efforts to improve their economic situation.

On the other hand, failure to deal adequately with our economic problems could lead to outcomes that would be unsatisfactory, with slow growth, higher inflation, and a reversal of the progress made in overcoming external debt problems. Thus, the fundamental message is that a favorable outcome will not be handed to us on a silver platter. We must all work diligently to achieve it.

I can assure you that the United States will do its share. We recognize that many of you are concerned about the size of the U.S. budget deficit. Frankly, I am concerned, too, and I can assure you that we view the need to reduce our budget deficit as a matter of the highest priority. President Reagan is determined to reduce the budget deficit substantially. The President has recently secured an agreement with the Senate leadership on the most ambitious deficit reduction program we have ever embarked upon. If approved and fully implemented, this program will ensure a $300 billion reduction in our deficit over three years.

Reducing our deficit will be part of our broader effort to sustain strong, non-inflationary growth in the world economy and to maintain an open trading system. We should not be surprised to see U.S. real GNP growth slowing from its nearly 7 percent pace in 1984. But all the signs indicate that conditions in the United States have been put in place for sustained non-inflationary growth in the 4 percent range.

Our continued strong stance against inflation has contributed to a fall in U.S. interest rates since last summer. We view firm anti-inflation policies as the surest way to reduce inflation expectations, and thereby reduce the inflation premia that are built into interest rates. The lags in inflation expectations have been long. But we believe people are beginning to accept lower inflation as sustainable, and are adjusting expectations accordingly.

As U.S. growth slows, economic policies and developments in Europe and Japan in particular will become increasingly important. Recent growth in Europe, however, has not reduced unemployment. In fact, unemployment rates in France have risen by nearly two percentage points since the end of 1982, by one percentage point in Italy, and by 0.6 percentage point in Germany and the U.K. This is a worrisome problem.

It is our view that the ability of European economies to restore sustainable growth and job creation will not be accomplished through attempts to stimulate demand through more government spending. Prompt, comprehensive measures are needed to address structural rigidities, particularly in labor and capital markets. I believe that it is critical, for example, that Europe remove impediments to hiring and firing of workers so that firms possess flexibility and have economic incentives to create new jobs. Disincentives to the job search must be removed and marginal tax rates must be lowered so that workers have an economic reason for seeking new jobs. Firms also need to be able to raise capital in the most efficient way possible. This requires removing capital market controls and rigidities, and allowing for increased competition in capital markets. Such steps could also encourage repatriations of capital. Providing for more attractive investment opportunities would produce a better allocation of capital within economies.

The very high ratios to GDP of public expenditure and public revenue in many European countries demonstrate the existence of both macroeconomic and structural problems which are a hindrance to stable growth over the medium term. Many European expenditure-to-GNP ratios are in the range of 50-60 percent. These ratios clearly need to be reduced. Policies to cut expenditures must, of course, be accompanied by prudent anti-inflationary monetary policy.

In Japan, remaining impediments to open markets, particularly for goods, services and capital, also seriously affect that country's economic performance, including the exchange rate of the yen. They also contribute to world economic imbalances. For example, at a time when the LDCs have been working to reduce their trade deficits, Japan added to its trade surplus with the LDCs.

Japan has made significant strides in liberalizing its capital markets and stabilizing the yen, although further progress is needed in this area, particularly with regard to domestic financial market liberalization. What is needed now is determined and forceful action by Japan to complement these measures by opening up its markets for goods and other services.

If the European and Japanese economies are to supplement the United States in supporting LDC adjustment efforts, their imports from LDCs will have to increase significantly. Their combined imports from LDCs would have to rise by $25 billion over the next couple of years to duplicate the growth stimulus ignited by the U.S. expansion. This would represent a growth of some 25 percent in the current level of Japanese and European imports from LDCs.

If all of the industrial countries do their part in addressing their own problems, I believe that the chances are good for industrial country growth higher than the Fund staff

expect: perhaps in excess of 3 1/2 percent per year as a base case rather than the roughly 3 percent the staff assumes. Even 4 percent would not be out of the question if we are willing to act and not let our sights be lowered by the experience of the 1970s. But even a 4 percent growth rate in the industrial world can only facilitate growth elsewhere; it cannot make growth happen.

The policy choices of individual developing countries will continue to determine whether or not they can take advantage of the growth opportunities that are available. In addition to sound monetary, fiscal and exchange rate policies, more active use needs to be made of pricing, marketing, and wage policies; trade and financial market liberalization; and efforts to improve the environment for foreign direct investment. All of these can contribute importantly to LDC growth and adjustment. Countries which have been undertaking adjustment efforts over a number of years but are not yet on a clear path to steady growth and sustainable balance of payments positions must in particular reinforce their efforts with prompt structural measures.

LDC dependence on foreign savings is still too high, especially in light of the likely limits on the availability of foreign portfolio financing and taking into account the existing debt burden. The ratio of investment to GDP in many developing countries has also fallen at a time when higher and more efficient investment levels are needed in order to attain an acceptable growth path. Mobilization of domestic savings is, therefore, crucially important to sustainable economic growth and external positions.

Much better performance on inflation in some developing countries is also essential if domestic savings are to grow and be employed efficiently in productive investment, rather than being diverted to speculative or defensive uses, or to capital flight. Unfortunately, traditional fiscal, monetary, and other macroeconomic policies have not yet been fully employed to combat inflation in some high-inflation countries. Beyond that, taking into account the deficiencies and lags in effectiveness of these standard tools, they will probably need to be complemented and reinforced by other measures, such as specific plans for revising inflationary expectations, wage policies, import liberalization, and reforming financial institutions and instruments.

In sum, if all of us -- industrial and developing countries alike -- take the steps we can, we can look forward to a still brighter future, measured not just by higher growth rates, lower debt and debt service ratios, but also by higher standards of living for all our people.

The Role of the IMF

During the last few years, the IMF has demonstrated why it continues to be the world's central international monetary

institution. The Fund has responded in a timely and effective manner to the international debt problem. Since 1981, more than 100 countries have received over $40 billion in temporary balance of payments financing in support of their adjustment efforts. The IMF's policy advice has helped in the formulation and implementation of the sound domestic policies necessary for restoration of growth and sustainable external positions. Furthermore, the Fund has served importantly as a catalyst for encouraging other lenders to reschedule existing debt. This is particularly important since the IMF has not provided and cannot provide the bulk of external financing needs for developing countries.

As the pace of global recovery increases and adjustment efforts succeed, it is to be expected that new IMF financing would diminish and that members would repay outstanding loans so that the resources would be available for new IMF lending. The United States has become increasingly concerned, however, that the prolonged use of IMF resources is undermining the revolving character of IMF financing and creating undesirable pressures for borrowing and quota increases. Moreover, the failure of certain countries to meet their payment obligations to the Fund in a timely manner weakens the IMF's financial integrity and its credibility as a sound, prudent institution. Despite difficult economic problems, the vast majority of members meet fully their IMF obligations and all should be expected to do so.

The IMF's raison d'etre as a financial institution is to provide conditional lending in support of effective economic adjustment to deal with temporary balance of payments difficulties. The flexible application of appropriate conditionality is critical to the Fund's efforts to provide the sound world economy and stable international monetary system on which all of us depend and from which we all benefit. Measures that would weaken the Fund's ability to promote sound policies would result in less total financing and a poorer world economy. In the final analysis, all of us would be worse off, particularly the weakest among us.

The IMF's ability to encourage sound policies extends beyond its function as a source of conditional financing. The IMF's surveillance responsibilities are designed to assure that those countries which do not need IMF financing, including the largest members, fulfill their obligations to pursue policies that will provide orderly underlying economic and financial conditions that are the prerequisite for external stability.

IMF Surveillance

The United States has attached considerable importance to the strengthening of IMF surveillance as a key means of encouraging sound economic policies in member countries. More effective surveillance can thereby contribute to a more effective functioning

of the international monetary system and an expanding world economy. Current surveillance principles and procedures are based on the principles agreed upon in 1977, and subsequently revised to a modest extent. However, the evolution of surveillance has, frankly, lagged behind world economic developments in recent years. We must take concrete steps to ensure that surveillance mechanisms meet today's needs. Indeed, many of the problems which have plagued the world economy during the 1980s might have been avoided, or at least might have been less serious, if IMF surveillance had been more effective during the period when underlying difficulties were initially emerging.

In our view it is essential to develop further both the content and procedures of IMF surveillance in order to foster greater mutual understanding of our individual situations and to enable the IMF to support and influence positively member governments in their efforts to develop sound underlying policies that will promote non-inflationary growth. IMF surveillance should encompass the full range of economic policies affecting exchange rates and economic performance, including monetary, fiscal, structural, pricing, and trade policies. Any approach which focuses primarily on exchange rates _per se_, and exchange rate policies narrowly defined, will not permit the kind of comprehensive and balanced judgment of a country's policies and performance which is necessary for effective surveillance.

The IMF staff paper prepared for the Interim Committee discussion of surveillance includes a number of the specific proposals which could provide a sound basis for a strengthening of surveillance. Included are such steps as higher-level participation in IMF Article IV consultations, special or supplemental consultations where appropriate, greater focus on the interaction of members' policies, and follow-up reports on measures implemented since the last round of annual consultations. We also believe that increased public awareness of IMF consultations is important, and that the public release of an abbreviated version of the Managing Director's summing up of Board discussions at the conclusion of Article IV consultations could be very useful. Such a statement could provide a brief assessment of a member country's policies and prospects as a complementary means of encouraging sound policies.

Finally, we believe that "enhanced" surveillance is a potentially important part of the Fund's activities, in particular where additional IMF financing may not be appropriate or desired, but where a continued Fund presence may be important to the individual member, to its potential creditors, and possibly to the system as a whole. The Fund has already accepted a monitoring role in connection with some private sector multi-year rescheduling arrangements. We believe that enhanced surveillance can also play a role in connection with certain cases involving prolonged use of IMF resources, where continued Fund policy advice and support may be helpful to both the member and its

creditors, but where further IMF financing may not be consistent with the temporary nature of IMF financing. In such cases, cooperation between the IMF and the World Bank is particularly important.

The Fund should continue to proceed cautiously, aware of both the risks and benefits of enhanced surveillance. Such arrangements should be used selectively and should be associated with sound, comprehensive adjustment programs. They should in no way be substituted for sound policies. Furthermore, they should generally involve quantified economic targets. Such targets will be particularly important if countries with good performance records wish to seek enhanced surveillance in conjunction with possible multi-year rescheduling arrangements. Such enhanced arrangements also should not implicate the Fund in any way as a guarantor for other financing.

The studies regarding the international monetary system which have been underway within the Group of Ten recognize the need for more effective IMF surveillance, and are likely to emphasize specific proposals toward that end. As I indicated last week, the United States attaches considerable importance to these studies of possible improvements in the international monetary system. We are therefore prepared to consider the possible value of hosting a high-level meeting of the major industrial countries, following the conclusion of the studies, in order to review the various issues involved in transforming their findings into appropriate action.

Such a meeting could provide further impetus to strengthening the international monetary system through the IMF, in particular through the upcoming review of the G-10 studies by the IMF's Interim Committee. For while the major industrial countries must do their part to strengthen the system, we cannot do it alone. It will be necessary for each of us, industrial and developing countries alike, to accept our responsibilities to improve the system.

This is reflected in the fact that it is the Interim Committee, representing the entire membership of the IMF, that has the responsibility, among others, to advise and report to the Board of Governors with respect to the "management and adaptation of the international monetary system." It is this Committee, then, that will have the basic task of considering how the G-10 studies can best be implemented to strengthen the international monetary system.

<u>SDR Allocation</u>

I'd like to turn briefly now to the question of a new allocation of SDRs. The United States continues to oppose an allocation.

The IMF's Articles of Agreement require that there be a "long-term global need" for new reserves prior to a decision to allocate. However, the data indicate that global reserves have grown an average of 10 percent per year since 1982. In fact, during the same period, reserves of the non-oil producing LDCs have grown even faster, at an average annual rate of 16 percent.

Taking these and other factors into account, we do not believe that the case has been made for an allocation.

The key to resolving the liquidity problems of individual countries lies with effective economic adjustment policies. Experience suggests that even countries in very difficult positions today could conceivably restore their creditworthiness in private capital markets through implementation of appropriate adjustment measures.

We also remain concerned that creation of a large amount of unconditional liquidity could send the wrong signals about the need to continue to fight inflation as well as detract from the necessary focus on adjustment efforts.

Finally, I would point out that because new SDRs would be distributed on the basis of IMF quota shares, an allocation would be of very little benefit to either the major debtors or the poorest LDCs.

Trade

The excellent papers on trade prepared for our meetings by the Bank and Fund staff convincingly demonstrate the benefits to developed and developing economies of maintaining economies open to world competition. The studies make clear the costs of inward-oriented policies, such as import substitution programs, in terms of growth potential, job creation, and overall performance. Nonetheless, because of lower than desired global growth, persistent high levels of unemployment, structural changes in demand and supply, strains arising from the debt situation, and many other reasons familiar to us all, protectionism has spread. Efforts to strengthen the open multilateral trading system have been insufficient.

Meeting here, we can contribute to trade liberalization by agreeing on basic policy approaches and then working within each of our governments to implement them.

First, we should recommit ourselves to resist protectionism. In my country, the sharp increase in imports over the last few years has led to strong pressures for protection. Nonetheless, we have generally succeeded in keeping our market open. The United States now accounts for 60 percent of developing country exports of manufactured goods to the industrial countries. Mindful of the benefits of our open market to the developing countries, to the industrial countries, and to ourselves, my

government will continue to resist pressures to close our market. We urge other countries to do the same.

Second, we must begin to dismantle existing trade restrictions when possible. The United States took a significant step in this regard by deciding not to ask Japan to continue its voluntary export restraint on automobiles.

Third, we should support a new round of trade negotiations. We can accomplish far more in fighting protectionism and rolling back barriers by working together than by trying to accomplish these goals unilaterally. Multilateral trade negotiations permit us to counterbalance powerful groups in our economies that benefit from protection with those sectors in our economies that would benefit directly by a decrease in barriers and a more stable and comprehensive set of trading rules.

Such negotiations should be broad. All barriers to trade in goods and services should be on the negotiating table, whether tariffs, non-tariff barriers, or newer forms of protection.

Crucial for the success of the negotiations is that both industrial and developing countries participate fully. Developing countries should become full partners in this enterprise. By becoming actively involved in trade negotiations, the developing countries can obtain greater access to other markets and appropriately open their own markets. Only by actively participating in negotiations to reduce barriers can countries obtain these twin benefits: better access for exports and a more open economy.

The Bank and Fund have played an important role in encouraging trade liberalization through their lending programs and through consultations with member countries. We applaud these efforts, and encourage these institutions to continue and even strengthen their liberalization role, while maintaining close ties with the main international trade organization -- the GATT.

At the just concluded OECD Ministerial the industrial countries agreed that a round of negotiations should begin as soon as possible. The broader membership of this Committee should give impetus to such a round by endorsing it and urging that it begin in early 1986. In order to prepare for such negotiations, we encourage our GATT partners to join us in a meeting of senior officials in the GATT on July 22 of this year.

Capital Flows, Debt and Creditworthiness

As we meet, a chief concern of many developing countries is how they will restore creditworthiness and generate and attract the resources needed to finance development. These concerns are a legacy of the debt crisis that emerged in many countries in 1982. The accompanying loss of creditor confidence resulted in substantial flight of domestic capital, and had a deeply

inhibiting effect on commercial bank lending, and to some extent, on the export credit agencies.

Because the crisis took years to develop, it will take some time for debt burdens to be reduced to more manageable proportions. Fortunately, a good beginning has been made. As is clear from the review of recent economic experience, growth in industrial country export markets and the decline of interest rates have markedly improved the environment in which the developing countries are operating. Many of them have tackled their problems vigorously through IMF-supported programs. A number of countries undergoing these difficult adjustment efforts have started to grow again while meeting their debt obligations.

Even as the general situation improves, we will continue to be faced with country problems of varying degrees of gravity from countries that either have not adjusted sufficiently or have not shared in the growth of export markets. These lingering problems do not detract from the essential success of the present approach to debt problems.

The debt strategy is a flexible, case-by-case approach that calls for continued debtor country adjustment efforts and non-inflationary industrial country growth. Commercial banks have an important role to play in the process, and continued prudent commercial lending is essential. This approach has proven adaptable to a changing international situation.

At the same time, we must recognize that in the financial environment of the 1980s neither commercial bank lending nor official development assistance will grow as rapidly as in the past. As a result, attracting capital for development will require developing countries to implement policies which will increase domestic savings and make investment attractive to private investors, both domestic and foreign. It is clear that most successful developing countries have relatively higher savings rates and therefore increased investment rates.

There is no magic to these policies. Increasing domestic savings rates, attracting domestic and foreign capital into investment, and reattracting flight capital all require the same commitment to stable, non-inflationary growth policies. Capital controls are not the solution; they do not address underlying causes of the problem. Policies that create a healthy investment climate are those that promote sustained growth, adjustment and development.

For the more advanced developing countries, private bank lending continues to play a dominant role in external financing. The pace of net new commercial bank lending has slowed from the $45 billion pace in 1981-82 to roughly $14 billion last year. It still remains a key ingredient in total external financing flows, but it is an element over which industrial country governments can have only limited influence. The key to improved

relations with commercial banks is improving creditworthiness of borrowers. It is the borrowers' own policy actions which determine this perception.

Our governments must avoid specific intervention in the commercial decision making process of our private institutions. Nevertheless, the industrial countries have a strong interest in encouraging commercial banks to avoid actions that could be counterproductive. In fact, the banking community reacted to the emergency of widespread financing problems two years ago in a generally constructive manner. They have played an important role in helping to work out difficult financial problems. Banks have been supportive of adjustment programs, both in rescheduling packages and in providing net new lending, where appropriate, and have negotiated multiyear reschedulings in some cases, in order to facilitate longer term adjustment efforts.

Looking ahead, it is important that private banks maintain a broad view of their role, beyond the initial response to the debt problems of the larger developing countries. They should continue to support all countries -- including smaller countries -- that are performing well under economic adjustment programs.

Net new flows can help strengthen the adjustment process and improve the quality of outstanding credit. Our Bank regulatory authorities recognize the importance of this policy.

Export Credit

Export credit agencies also play a key role in supporting individual country adjustment efforts by maintaining critical imports during periods of constrained external financing. Decisions of export credit and insurance agencies regarding provision of credit ("cover") are generally determined case-by-case on the basis of competitive factors and commercial prudence. This mix of considerations has sometimes resulted in a tendency to maintain cover during the build-up of a debt problem and then to terminate cover abruptly when the problem becomes overt. In some cases, resumption of cover has been delayed well after agreement upon an IMF adjustment program and conclusion of the initial debt rescheduling agreement in the Paris Club.

The first step in addressing this problem is closer coordination in identifying potential debtor problems as they develop. In this context, it may be appropriate to tighten cover during the early phases of a troublesome debt situation.

The critical requirement in restoring access to credit must be the adoption of a sound economic adjustment program. Such a program may involve rescheduling official and private debt and new credit may be required. Official export credit agencies have a responsibility to support such adjustment efforts by

joining with private financial institutions and the IMF in providing new credits, consistent with their requirements for assurance of repayment.

Turning to another facet of export credit agency operations, we believe export credits can and should contribute to the development process in a way which is compatible with their commercial focus, by supporting financially and economically sound projects. The background documents prepared for this meeting suggest we explore the appropriate role of the World Bank in improving the development impact of export credits. We believe countries should welcome IBRD technical advice in assessing the financial and development merits of a particular project. Such a role for the Bank would be useful to credit agencies and borrowers. However, given the range of commercial and financial considerations in export credit transactions, it would be difficult to structure and agree upon a more formal role for the IBRD which would allow some form of direct influence on export credit agency activities.

Official Development Assistance

We firmly believe that official development assistance is an essential source of external financing for many of the poorer countries. If used properly, in a supportive policy environment, it can be especially critical to the future growth prospects of the poorest countries. There are compelling humanitarian and economic reasons to continue to improve the effectiveness of ODA to developing countries. The United States remains committed to this goal and is the largest provider of ODA with about $9 billion budgeted for U.S. fiscal year 1985.

All of us understand that the flow of concessional resources has been constrained in recent years. Given today's budgetary environment and the recognized need to constrain budgetary expenditures, available financial resources must be used wisely and effectively. Resources must be channeled increasingly to the poorest countries -- those which have the least access to private market financing.

The economic policy framework and the incentive system in which ODA can be used is the single most important contribution that potential recipient governments can make in the partnership working for their own development. Careful and improved coordination of policy advice among the IMF, IBRD, regional development banks, bilateral donors and consultative fora remains a fundamental responsibility of all.

We support the expanded World Bank consultative group framework and its efforts toward increased aid effectiveness. The Development Committee Task Force on Concessional Flows is another useful step in seeking ways to improve aid effectiveness and we look forward to reviewing its work.

Foreign Investment

Foreign direct and portfolio investments are especially productive forms of capital inflow, with several characteristics that make them attractive alternatives to commercial bank lending. While commercial debts involve interest payments that must be made regardless of economic conditions or the performance of the borrowing entity, profit remittances from foreign investments depend on the economic performance of the investments themselves. With regard to foreign direct investment, LDCs can also gain transfers of technology, managerial and marketing skills. Direct investments create employment and contribute to diversification of the host economy, and often result in export expansion.

However, foreign investment is obviously being underutilized. In 1975, foreign direct investment accounted for 20.4 percent of external finance for developing countries. In 1983 the share of foreign direct investment in external financing dropped to 8.6 percent. Countries should review their policies that restrict foreign investment and conflict with their need for capital.

Capital market development is an important factor in facilitating investment levels by improving intermediation between savings and investment. In this context, we support the work of the International Finance Corporation (IFC) in providing technical assistance to create new financial institutions and improve the functioning of existing domestic capital markets.

In seeking ways to facilitate direct investment, the United States has firmly supported World Bank efforts to develop a multilateral investment insurance scheme. We believe a multilateral investment guaranty agency (MIGA) which will stimulate flows of additional foreign direct investment to developing countries and encourage a policy environment which can attract investment will be an important part of the development process.

We welcome the progress the Bank has made in developing a sound proposal. We urge other governments to join us in an effort to finalize the draft convention for establishing the MIGA.

World Bank

Assuring that all countries, especially the poorest ones, participate fully in the process of growth and development is a challenge of overriding importance. Looking at the world economy I am convinced that economic policies providing the incentive for a free market which rewards hard work and legitimate risk are the most likely to produce development successes. It is critically important that foreign assistance programs, both bilateral and multilateral, complement and encourage viable domestic market-oriented policies.

The operations of the World Bank and the regional development banks were specifically designed to encourage appropriate policies and thereby assist in the economic growth of their developing country members. As President Reagan stated at last September's Annual meetings, we value highly the Bank's proven expertise as an investment project lender, and its ability to provide helpful policy guidance and technical assistance, and to act as a catalyst in encouraging private enterprise and investment capital.

I believe that the World Bank should continue to play a prominent role in the longer-term development programs of its borrowers and, as appropriate, in their medium-term adjustment efforts. I also recognize the complexities and scale of the diverse economic situations which developing countries are likely to confront for the remainder of the 1980s. During this period of immense challenge -- which also poses great opportunities -- it is important that all of us work constructively to ensure that the Bank's very considerable financial and technical resources are employed in the most effective possible way.

I therefore welcome the opportunities which the Future Role of the Bank review provides for charting a comprehensive and realistic medium-term strategy for future Bank operations. In this context, I am particularly pleased at the increased recognition accorded to the vital link between the effectiveness of Bank programs and the extent to which they are successful in strengthening economic policies in borrowing countries. More effective use of development resources in support of policy reform is central to the task ahead.

In looking to the future, we want the Bank to continue emphasizing its mandated responsibility for solid investment project lending. This is where the Bank can play its most valuable role. Its unique expertise provides a comparative advantage to leverage its resources in support of appropriate domestic adjustment policies. At the same time, we recognize that the Bank must remain flexible to adapt effectively to the changing circumstances of individual member countries.

The Structural Adjustment Lending (SAL) program is a good example of such pragmatic and financially responsible flexibility. We believe the Bank has used its experience with SALs to good effect and that, on the strength of their record in facilitating policy adjustment, the SAL program is a valuable instrument for supporting member countries willing to formulate and implement programs of structural adjustment. In sum, the program has been effective and we believe it should be retained and even prudently expanded, as long as there is a serious need and desire for more SALs linked to appropriate policy reforms.

In addition to the SAL program, we recognize that sector adjustment loans can be instrumental in encouraging adjustment as long as there is effective policy reform. Such sector

adjustment loans may be particularly appropriate in low-income member countries where institutional weaknesses hinder the design and implementation of more comprehensive policy-based lending.

The current Bank approach to lending, in effect, builds upon the Bank's traditional strength and employs selective use of existing non-traditional lending instruments in support of policy reform. We view this as a sound basis for future operations, particularly since a strengthening of the world economic recovery and a lessening of structural imbalances should over time reinforce the Bank's traditional role as a project-based investment institution.

This flexible response of the Bank, in parallel with the efforts undertaken by the Fund, represents successful adaptation by these institutions to an unprecedented set of difficult developing country adjustment problems. However, the pragmatic response of the institutions has in some cases led to overlapping responsibilities and a heightened need for cooperation. The United States supports concrete, practical steps to strengthen Fund/Bank cooperation and ensure that Fund and Bank policy advice and technical assistance are complementary. We therefore welcome the priority attention both the Fund and Bank are giving to this issue and, for our part, intend to continue working actively with our colleagues in these institutions to secure meaningful results.

While we applaud prudent flexibility in the World Bank lending program, we would oppose efforts to enhance the Bank's balance of payments role in ways which would lead to an increase in lending without a constructive policy response by the borrower. The benefits of such lending would have little lasting impact on recipient countries. It would also jeopardize financial market perceptions of the quality of the IBRD's loan portfolio.

We also believe that Bank efforts to strengthen domestic institutions, rationalize public sector investment programs -- including sound sector pricing -- and improve the environment for private investment merit renewed support. In addition, financially prudent efforts to enhance the Bank's catalytic role by generating increased commercial bank and other co-financing -- without offering the umbrella of the Bank's preferred creditor status -- should continue to be encouraged.

Both IDA and the IFC have unique and special roles; IDA in encouraging policy reform and development in the Bank's poorest member countries, and the IFC in promoting private enterprise. The United States remains the largest single contributor to these affiliates, and we are committed to working with other members to increase their operational effectiveness. In the case of IDA, we believe that the countries of Sub-Saharan Africa, and other countries whose lack of creditworthiness precludes access to alternative financing, should have first claim on available resources as long as they can be used effectively.

Resource availability has an important bearing on both the operational aspects and the scale of future Bank lending. IDA is in the first year of a new replenishment; IFC has a capital increase proposal pending before its Governors; and a Selective Capital Increase was approved for the IBRD last year. The President's Report now seeks agreement to move forward on the negotiation of a new IBRD General Capital Increase. While the issue of resource availability must be kept under close review, I believe it is both unnecessary and unwise to be focusing on the issue of a new GCI at this time.

The IBRD can lend up to $13 billion annually indefinitely without a capital increase. This is a substantial sum. As we are well aware, demand for lending has dropped significantly and this year's IBRD commitments could well be below $11 billion. It is not clear to us how the Bank can increase its lending program significantly at this time, without weakening lending standards or displacing alternative sources of finance in creditworthy countries. A further consideration, as suggested in President Clausen's report, is the need to consider the Bank's capacity to borrow prudently the additional resources implied by another general capital increase.

The Problem of Sub-Saharan Africa

There is no question that the economic situation in Sub-Saharan Africa remains the most critical of any region in the world. The devastating effects of the prolonged drought in the region will continue to be with us for an extended period, even if more normal patterns of rainfall resume in the near future. Nonetheless, as the World Bank has indicated in its progress report on the Joint Program of Action, favorable developments in a number of countries have taken place over the past year. A return to more normal rainfall patterns in several key areas appears to be taking place, with an immediate, positive impact on agricultural production. Significant policy reform programs are underway in a growing number of countries, and prospects are good for real GDP growth in 1985 -- although still distressingly low -- for the first time in four years.

In this region, as elsewhere, the importance of government policies in creating a secure environment in which individuals have the incentives to save, invest and work, is paramount. The World Bank has a major role in this effort through its on-going project work and policy dialogue, and in its key role in preparing for an expanded number of Consultative Groups. We will continue to look to the Bank for leadership in this important area.

The United States remains very seriously concerned by the situation in Africa and recognizes the continued need for a generous response by the world donor community. We believe that IDA should place increased emphasis on Sub-Saharan Africa, and we are directing a larger share of our own bilateral

resources to the region. We estimate our assistance program in U.S. fiscal year 1985 at $775 million in addition to $900 million in food aid. We intend to use our bilateral resources to support policy reform, and to coordinate these efforts closely with the Bank's Special Facility and other donors. We continue to support the African Development Bank and Fund, where our contribution to the most recent Fund replenishment represents a 50 percent increase over our previous commitment level.

With diligent and continued efforts we can help Sub-Saharan Africa put itself back on the road to economic growth.

Conclusion

These special meetings of the Interim and Development Committees to consider critical economic issues constitute a new commitment to international dialogue by the members of these bodies.

Six months ago, my predecessor joined with you in calling for these special sessions in order that we might examine in a comprehensive way the policy approach necessary to move toward a sustained pattern of global growth. At these meetings, we will review the progress that has been made to reduce external imbalances and to improve growth prospects in the world economy in the second half of the 1980's.

In reviewing our economic progress, we should all recognize that it has entailed extraordinary acts of courage among nations, both singularly and collectively. Significant economic adjustment, some of it painful, has taken place. But our work is not yet finished.

Many countries still face fundamental problems. Despite expanding world trade, debt service obligations in many cases are high in relation to export incomes. We can all agree that adjustment efforts must be continued. The environment for trade and investment flows must be liberalized and development assistance and other capital flows should be used efficiently to help those countries that are making determined adjustment efforts.

Our experience indicates that we are on the correct path. We firmly believe that sustained and widely shared growth is possible. But we also recognize that together we will continue to face some difficult policy choices. The need for continued discussions and mutual understanding only increases as we seek to design a policy blueprint for growth.

I look forward to working with you to identify fresh approaches to the issues and problems we face. My hope is that we can reach new levels of understanding and a renewed determination to work together toward a global environment which provides the basis for sustained growth and future prosperity for all nations.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE April 22, 1985

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,510 million of 13-week bills and for $6,508 million of 26-week bills, both to be issued on April 25, 1985, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 25, 1985			:	26-week bills maturing October 24, 1985		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.56%	7.81%	98.089	:	7.83% a/	8.26%	96.042
High	7.65%	7.91%	98.066	:	7.90%	8.34%	96.006
Average	7.62%	7.88%	98.074	:	7.87%	8.31%	96.021

a/ Excepting 3 tenders totaling $20,040,000.

Tenders at the high discount rate for the 13-week bills were allotted 60%.
Tenders at the high discount rate for the 26-week bills were allotted 4%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 407,150	$ 147,150	:	$ 389,240	$ 39,240
New York	14,285,280	3,990,480	:	15,071,250	4,619,250
Philadelphia	35,675	35,675	:	20,775	20,775
Cleveland	62,010	59,010	:	37,745	37,745
Richmond	51,875	51,875	:	71,615	51,815
Atlanta	53,105	53,105	:	43,565	43,565
Chicago	1,073,880	368,880	:	1,014,615	274,615
St. Louis	77,465	62,465	:	84,725	60,125
Minneapolis	37,210	37,210	:	41,930	41,930
Kansas City	65,510	64,510	:	45,610	44,650
Dallas	31,865	31,865	:	17,965	17,965
San Francisco	2,070,125	1,246,125	:	1,657,995	837,195
Treasury	361,470	361,470	:	419,125	419,125
TOTALS	$18,612,620	$6,509,820	:	$18,916,155	$6,507,995
Type					
Competitive	$16,211,395	$4,108,595	:	$16,194,435	$3,786,275
Noncompetitive	1,259,390	1,259,390	:	1,050,920	1,050,920
Subtotal, Public	$17,470,785	$5,367,985	:	$17,245,355	$4,837,195
Federal Reserve	1,000,135	1,000,135	:	893,000	893,000
Foreign Official Institutions	141,700	141,700	:	777,800	777,800
TOTALS	$18,612,620	$6,509,820	:	$18,916,155	$6,507,995

1/ Equivalent coupon-issue yield.

B-102

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Not Reviewed by the Office of Management and Budget
Due to Time Constraints

For Release Upon Delivery
Expected at 9:30 A.M., E.S.T.
April 22, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the views of the Treasury Department on three bills (S. 476, S. 420, and S. 632) relating to corporate acquisitions. These bills appear to be prompted by the recent surge in merger activity generally, but are particularly directed at hostile merger activity. The bills would substantially penalize, if not render economically impossible, mergers and acquisitions that are considered "hostile."

We do not believe that Congress should enact special tax provisions aimed only at hostile as opposed to friendly acquisitions. Indeed, we do not believe that Congress should amend the tax laws for the purpose of discouraging mergers and acquisition activity generally.

We do not know all of the economic and other reasons behind the recent flurry of activity. We doubt, however, that the tax laws are the driving force, but rather suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale,

increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions.

The bills that are the subject of today's hearing would discourage hostile takeovers by disallowing interest deductions with respect to certain indebtedness and mandating a section 338 election for certain stock purchases. In addition, the bills would discourage attempted takeovers by imposing an excise tax on certain profits realized by persons who take substantial investment positions in companies that are the subject of an attempted takeover. These profits have recently been referred to as greenmail profits. The bills also would clarify that under current law no deduction is available with respect to any greenmail payments.

The Treasury Department opposes these bills. As a matter of tax policy, we do not believe hostile acquisitions should be treated differently under the tax laws than friendly acquisitions, nor do we believe that a clear distinction can be drawn. Thus, we believe that interest deductions and section 338 elections should be equally available for hostile and friendly acquisitions. Further, we do not believe that certain gains from sales or exchanges of stock, labeled greenmail profits, should be subject to an excise tax. Finally, while greenmail payments are not deductible under current law, we would not be opposed to a statutory confirmation of this point.

Hostile Versus Friendly Acquisitions

All of the bills that are the subject of today's hearing would limit interest deductions, and both S. 632 and S. 420 would mandate section 338 elections, for all hostile acquisitions. Hostile acquisitions are defined in two different ways, however. S. 476 defines the term "hostile acquisition" generally as an acquisition of corporate property or stock by persons who have acquired a 20 percent or greater interest in the target corporation within the preceding year, if the transaction, before consummation, is not formally approved by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. No member of the board would be treated as independent if such member is an officer or employee of the corporation or was nominated by the persons making the acquisition.

Both S. 632 and S. 420, framed more broadly than S. 476, apply to acquisitions by any persons, if the acquisition is pursuant to a "hostile offer." The term "hostile offer" turns on the same factor as S. 476 -- disapproval by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. The

definition of an independent director is more restrictive under S. 632 and S. 420 than S. 476, as it not only excludes from the definition a person that is an officer or employee of the target corporation, but also any person that has substantial financial or commercial ties to that corporation, except for ownership of stock.

We do not believe the tax consequences of corporate acquisitions should turn on whether a corporation's independent directors approve or disapprove of the acquisition. Moreover, the effect of these bills would be to bring new and extreme pressure to bear on the decision making processes of independent directors. Because of the harsh tax consequences resulting from characterization of an acquisition as hostile, independent directors would in effect have a veto over corporate acquisition decisions. On the other hand, there may be substantial enough pressures on the independent directors that would, under certain circumstances, tend to make them vote for, rather than against, a proposed acquisition. For only by their favorable votes could the sanctions imposed by these bills be avoided. Such pressures would seem to undermine the very rationale for independent directors.

Further, many closely held corporations do not have independent members on their boards of directors. In such cases, the tax penalties could not come into play no matter how vigorously a takeover is resisted. The bills do not suggest any rationale for this arbitrary distinction. If these tax penalty provisions were enacted, however, companies would have an incentive not to have independent directors. We doubt that the sponsors of the bills intend such a result.

We believe very strongly that the market place (i.e., shareholders rather than independent directors) should determine whether a proposed acquisition is economically beneficial. The tax laws should not bias this decision towards friendly or against hostile acquisitions, as a hostile acquisition may turn out to be an economically beneficiary acquisition. Only a free market can make the optimal economic decision.

Disallowance of Interest Deductions on Certain Hostile Acquisitions

All of the bills before the Subcommittee limit the deductibility of interest incurred in connection with "hostile" takeovers. The genesis of these bills apparently stems from the publicity received by a number of recent acquisitions financed by the use of so-called junk bonds (i.e., high risk, high yield subordinated debt) and a concern that the current tax treatment of interest may encourage mergers, especially hostile acquisitions. The basic structure of our current income tax system may encourage corporations to utilize debt rather than

equity in financing operations or acquisitions because of the more favorable tax treatment of interest compared to dividends and the arbitrage potential from debt financing.

S. 476 would disallow a deduction for any interest paid or accrued during the taxable year with respect to "hostile acquisition indebtedness." Hostile acquisition indebtedness is defined as any "junior obligation" issued after February 18, 1985, in connection with a hostile acquisition. A "junior obligation" is any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued by any person which, upon issuance, bears any one or more of the following characteristics: (1) the indebtedness is expressly subordinated to the payment of any substantial amount of unsecured indebtedness of the issuer or the corporation that is the target of the hostile acquisition, (2) the indebtedness is issued by a person whose assets are (or following the hostile acquisition would be) comprised predominantly of the stock of the target corporation, cash, and cash equivalents, or (3) the indebtedness bears a rating from any nationally recognized rating agency which is at least two ratings inferior to the rating from such agency in respect of any other substantial class of indebtedness of the issuer or the target corporation. S. 476 is effective with respect to interest paid or accrued with respect to obligations issued after February 18, 1985.

S. 632 differs slightly from S. 476 in that it disallows a deduction for any interest paid or accrued on indebtedness incurred or continued to acquire (or carry) stock or assets acquired pursuant to a "hostile offer." The definition of "hostile offer" differs only slightly from the definition of "hostile acquisition" in S. 476 as discussed above. S. 632 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock acquired after March 6, 1985. For assets acquired pursuant to a "hostile offer," S. 632 fails to provide a specific effective date for its application to indebtedness incurred or continued to acquire (or carry) such assets.

S. 420 is identical to S. 632 with respect to the disallowance of interest deductions, except that it does not apply to indebtedness incurred or continued to acquire (or carry) assets; it is limited to acquisitions of stock. S. 420 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock which is acquired after February 6, 1985.

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income,

and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may itself become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating asset as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. However, if the corporation is formed or availed of for the purpose of avoiding the second shareholder-level tax by permitting earnings and profits to accumulate instead of being distributed, there is imposed on the corporation a penalty accumulated earnings tax.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt-to-equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expense but no realization of the increase in value of the asset until its sale or disposition. In such cases, the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions also leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern this Subcommittee, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

One of the bills, S. 476, would deny deductions for interest paid on high yield, subordinated bonds used to finance hostile acquisitions. The concern generating the bill may have been that a number of these bonds, referred to as "junk bonds," have been used in connection with recent highly leveraged acquisitions. There is a substantial argument that some of these bonds would be more appropriately classified as equity rather than debt. Although there are significant differences in the tax treatment of debt versus equity, it is extremely difficult to develop general rules to differentiate a debt interest from an equity interest. Section 385 lists certain factors that are to be taken into account in distinguishing debt from equity interests. Although section 385 was enacted in 1969, to date no satisfactory general rules have been developed. The Internal Revenue Service has administered this area, and will continue to differentiate instruments including junk bonds, on a case by case basis. S. 476 does not consider any facts and circumstances other than those enumerated in its definition of junior obligation and, therefore, may inappropriately characterize some junior obligations as equity.

Two of the bills before the Subcommittee, S. 632 and S. 420, address the disparate treatment of debt and equity and the potential arbitrage from debt financing by limiting interest deductions on all indebtedness incurred or continued in connection with hostile acquisitions. The tax arbitrage from debt financing generally is available, however, for all debt-financed corporate assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest, we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with hostile acquisitions. Any tax advantage to utilizing debt in a corporate acquisition is available both to hostile as well as friendly acquisitions. We believe that any remedy to limit the advantage to utilizing debt rather than equity to finance corporate acquisitions should be done in a neutral manner.

Mandatory Section 338 Election in the Case of Hostile Stock Purchases

Two of the bills before the Subcommittee mandate that in a hostile stock acquisition, the acquiring company is deemed to have made a section 338 election for the target corporation, and that certain other provisions of the tax law that generally apply when a section 338 election is made, do not apply.

Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock subject to a a section 338 election, the acquiring company obtains the benefits of a step-up in basis of the acquired assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336 and 337. Under those provisions, a corporation does not recognize gain (other than recapture and tax benefit items) on certain distributions, including liquidating distributions, made to its shareholders.

The General Utilities rule applies when a section 338 election is made. The election is available generally whenever one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. If such election is made, the basis of the assets of the target corporation is adjusted in a manner similar to the adjustments that would occur if the target corporation had sold all of its assets to the acquiring corporation in connection with a plan for complete liquidation. The target corporation does not recognize gain (or loss) on such deemed sale (except for recapture and tax benefit items). The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

There is generally no requirement that a purchasing corporation make a section 338 election for the target corporation. If no section 338 election is made for the target, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations.

S. 632 provides that in the case of any hostile qualified stock purchase, the purchasing corporation will be treated as having made a section 338 election with respect to such purchase. In addition, all gain, not just recapture and tax benefit items, will be recognized on the deemed sale of assets. Moreover, the basis of the target's assets deemed purchased will be reduced by the amount of tax imposed on the target corporation as a result of the deemed sale. S. 632 is effective for hostile qualified stock purchases after March 6, 1985.

S. 420 is identical to S. 632, except that there is no requirement that the basis of target's assets deemed purchased be reduced by the amount of the tax imposed on the target corporation on the deemed sale. S. 420 is effective for hostile qualified stock purchases after February 6, 1985.

The availability of the section 338 election does not create any significant tax incentives for either hostile or friendly acquisitions. The provision was intended to facilitate mergers and acquisitions by permitting the acquiring corporation to replicate the tax consequences that would follow from an asset acquisition without requiring an actual sale and transfer of those assets. In many cases, however, the tax consequences of an actual asset acquisition or a deemed asset acquisition under section 338 will be adverse. Acquiring corporations have always been able to avoid such consequences by acquiring the stock of the target corporation and forgoing any adjustment in the basis of the assets of the target company. There are no tax policy considerations that suggest this latter alternative should be foreclosed to hostile takeovers. If a mandatory section 338 election were imposed, there would be a substantial bias in the tax law against hostile acquisitions of certain companies, especially those with large recapture and tax benefit items. We do not believe there is a sound tax policy reason for imposing that bias.

Similarly, we do not believe that there is any sound basis for imposing the additional tax penalties on hostile stock acquisitions that are proposed by S. 420 and S. 632. Whether all gains, not just recapture and tax benefit items, should be recognized on an actual liquidating sale of corporate assets or a deemed sale pursuant to a section 338 election, is not an issue that should turn on whether the acquisition is hostile or friendly. Finally, the reduction in basis for the tax liability generated on the deemed sale in a mandatory section 338 election

prescribed by S. 632 is contrary to fundamental tax concepts, and amounts to an awkward and ill-conceived penalty on hostile acquisitions.

<u>Excise Tax on Greenmail Profits and Deductibility of Greenmail Payments</u>

Although the bills, as discussed above, generally attempt to distinguish between hostile and friendly acquisitions, they also deal with so-called "greenmail" paid and received in either hostile or friendly situations. As the term is commonly used, greenmail refers to a payment made by a corporation to a particular shareholder, often referred to as a "raider," who has purchased a substantial amount of the corporation's stock as part of a plan to acquire the corporation.*/ The offer to purchase the raider's stock is usually not made to all shareholders and is thus known as "greenmail." In exchange for the payment, the raider sells his stock to the target corporation and agrees to refrain from further attempts to acquire the corporation (a "standstill agreement"). Although the payment is made in exchange for the stock surrendered by the raider, it also may include reimbursement for expenses incurred by the raider in the takeover attempt.

In an attempt to eliminate greenmail payments, S. 476 and S. 420 impose a nondeductible 50 percent excise tax on any person who realizes "greenmail profits." Although greenmail, as described generally above, commonly refers to payments made by a corporation to an unwanted shareholder, both bills would sweep more broadly. In particular, greenmail profits are defined under

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*/ Because shares of a publicly traded target corporation are readily available for purchase on a stock exchange and the raider is generally not required to disclose his intentions until he has acquired five percent of the corporation's stock, the existence and identity of a potential raider may not be known by the target corporation until the raider has acquired the threshold five percent. Under the Williams Act, owners of five percent or more of a corporation's stock are required publicly to disclose the amount of their ownership and their plans with respect to the corporation. Accordingly, neither the target nor the market may be aware of a takeover attempt until the raider has acquired a substantial amount of stock.

S. 420 to include any gain realized by a "4-percent shareholder"*/ on the sale or exchange of any stock in the corporation if (1) the shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. Under S. 476, greenmail profits also arise from a sale or exchange if, at any time during the two-year period, any 4-percent shareholder submitted a written proposal to such corporation which suggests or sets forth a plan involving a public tender offer, regardless of whether a public tender offer is actually made.**/

The tax would not apply, however, to a gain realized by any person on the sale or exchange of stock in any corporation if, throughout the 12-month period ending on the date of such sale or exchange, such person had been an officer, director, or employee of the corporation or a 4-percent shareholder. Under the bills, therefore, the 50 percent excise tax would generally apply to gains realized by relatively large, short-term shareholders. Both bills would be effective for sales and exchanges made after February 6, 1985, except for sales or exchanges made pursuant to a written agreement in existence on February 5, 1985.

The 50 percent excise tax proposed by both bills is deficient in several respects. First, the Treasury Department does not believe that any valid tax policy is served by subjecting greenmail profits to an additional tax. If greenmail payments are determined to be contrary to the public interest, they should be deterred directly, rather than through use of the tax laws. For example, state corporate laws could be amended to prohibit greenmail payments. Moreover, if such payments are judged by shareholders to be generally unacceptable, direct action may be taken. In particular, as many corporations have done, corporate charters may be amended to proscribe such payments.

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*/ Under both bills, a "4-percent shareholder" means any person who owns stock possessing four percent or more of the total combined voting power of all classes of stock entitled to vote. For purposes of determining whether a person is a 4-percent shareholder, stock owned both directly and indirectly (through the application of section 318) is considered.

**/ The term public tender offer is defined under both bills to mean any offer to purchase (or otherwise acquire) stock if the offer is required to be filed or registered with any Federal or state agency regulating securities.

In addition to the fact that the tax law is an inappropriate tool to deter greenmail payments, the technique adopted by the bills seems overly harsh and imprecise. Under current law, gains realized on a sale or exchange of stock are generally treated as capital gains. Assuming the shareholder had no capital losses, gains from the sale or exchange of stock held for six months or less are taxed as ordinary income at a maximum rate of 50 percent, while gains from stock held for more than six months receive preferential tax treatment. In particular, individuals and other noncorporate taxpayers may exclude 60 percent of the gain from income, and corporations are subject to a maximum rate of 28 percent on such gain. Under the bills, therefore, an individual shareholder who owned four percent of a corporation's stock for six months or less at the time of the sale could be subject to a 100 percent tax on any gain, a 50 percent ordinary income tax and the 50 percent excise tax.*/ The Treasury Department does not believe that such a confiscatory rate of tax is appropriate under any circumstances.

Moreover, we believe that a 4-percent shareholder, like any other investor, is subject to the vagaries of the market and should be taxed as any other investor. We perceive no tax policy rationale for taxing a larger shareholder at a higher rate than a smaller shareholder on an identical economic gain.

In addition, although the bills are styled as imposing an excise tax on "greenmail," their reach is much broader. In particular, the excise tax would apply to any investor who purchased more than four percent of a corporation's stock, regardless of whether the shareholder purchased the stock with an intent to acquire the entire corporation. Such large shareholders could include a variety of institutional investors, such as pension plans, college and museum endowment funds, and large private investors. While such investors normally hold stock for periods of longer than one year, and would thus be excluded from the excise tax under both bills, situations would arise in which such investors, who had recently purchased stock, would want to sell. These situations would include a variety of circumstances under which institutions may be forced to liquidate an investment for external reasons, as well as the simple desire

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*/ Even if the shareholder had held the stock at the time of the sale for more than six months, but less than one year, the gain could be taxed at 70 percent. Corporate shareholders, depending on the length of their holding periods, would be subject to maximum effective rate of either 96 percent or 78 percent.

to take advantage of appreciation caused by an actual or anticipated public tender offer. We do not believe that such investors should be subject to the punitive tax proposed by the bills.*/ While such large shareholders could avoid application of the excise tax by holding their stock for more than one year, such potentially noneconomic behavior should not be required by the tax laws.**/

The final class of persons who might be subject to the greenmail excise tax are so-called "arbitrageurs." Such investors often take relatively large positions in a corporation's stock in anticipation of a tender offer at a price in excess of the prevailing market price. While such an investor may seek to benefit directly from a raider's attempt to acquire control of a corporation, we do not believe that any tax policy justifies taxing such person at exorbitant rates.

In summary, the Treasury Department believes that S. 420 and S. 476 represent an imprecise and overly harsh response to a perceived problem that may not be a problem at all. In any event, the solution does not reside in the tax laws. Consequently, we oppose the excise tax provisions in both bills.

Focusing narrowly on the tax treatment of "greenmail" by the corporation, S. 632 provides expressly for the disallowance of a deduction for any "greenmail payment." A greenmail payment is defined by S. 632 as any payment made by a corporation in redemption of its stock from a 4-percent shareholder if (1) such shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. A greenmail payment also would include any payment to a 4-percent shareholder or other person for any expenses paid or incurred in connection with a redemption or public tender offer. Like S. 476 and S. 420, the term 4-percent shareholder does not include a person who holds at least four percent of the total voting power of the corporation's stock throughout the one-year period preceding the redemption or who was an officer, director, or employee of the corporation throughout that period. There is no specific effective date for these provisions in S. 632.

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*/ Even if institutions that are exempt from the income tax also were exempted from the excise tax, it would still fall inappropriately on some large taxable investors.

**/ The one year exception in the bill would permit a raider to avoid the excise tax simply by holding a four percent interest for one year. While business and other factors might preclude the use of such a tactic, the exception will diminish the effectiveness of the provision.

Under current law, the repurchase of stock by a corporation, regardless of the amount of stock owned by the shareholder from whom the stock is redeemed, is a capital transaction that can not give rise to a deductible loss and payments made by a corporation in such a transaction are not deductible.*/ Consequently, the Treasury Department believes that the provision of S. 632 denying a deduction for redemption payments made to a 4-percent shareholder under certain circumstances represents a limited restatement of current law principles.

S. 632, however, contains an exception for redemption payments made to a shareholder who, throughout the one-year period preceding the redemption, was an officer, director, or employee of the corporation or a 4-percent shareholder. Moreover, S. 632 does not apply to redemption payments made to a shareholder who owns stock possessing less than four percent of the voting power of all the corporation's stock. Because redemption payments are not generally deductible under existing law regardless of the size or identity of the redeemed shareholder, we believe that S. 632 is defective to the extent that it suggests that redemption payments made to such shareholders could be deducted by a corporation.

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*/ The courts have held repeatedly that an amount paid by a corporation to redeem its stock is a nondeductible capital transaction. See H. and G. Industries, Inc. v. Commissioner, 495 F.2d 653 (3d Cir. 1974); Jim Walter Corp. v. United States, 498 F.2d 638 (5th Cir. 1974); Richmond, Fredericksburg and Potomac Railroad Co. v. Commissioner, 528 F.2d 917 (4th Cir. 1975); Markham & Brown, Inc. v. United States, 648 F.2d 1043 (5th Cir. 1981); Harder Services, Inc. v. Commissioner, 67 T.C. 584 (1976); Proskauer v. Commissioner, 46 T.C.M. 679 (1983). In one isolated case, Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), a court held that an amount paid by a corporation to repurchase its own stock was a deductible business expense in light of a showing that liquidation of the corporation was imminent in the absence of the redemption, no value would have been realized by the shareholders upon such a liquidation, and the redemption represented the only chance for the corporation's survival. Regardless of whether Five Star Manufacturing was correctly decided, it has since been strictly limited to its unusual facts, see, e.g., Jim Walter Corp, supra, and its continuing vitality, even on those unusual facts, is unclear, see Woodward v. Commissioner, 397 U.S. 572 (1970).

Despite the clarity of existing law and repeated losses in litigation, some corporations engaged in takeover fights have apparently taken the position that redemption payments may be deductible for Federal income tax purposes on the theory that they are made to "save" the corporation. We believe that treating redemption payments as deductible expenses under the circumstances contemplated by S. 632 is inconsistent with existing law. Nevertheless, we would not object to an express statutory confirmation that existing law bars the deductibility of redemption payments. If such an amendment were adopted, however, it should expressly deny deductibility for all redemption payments, regardless of the size or status of the shareholder, and the accompanying legislative history should state clearly that the amendment does not create any inference that the Congress believes such payments are deductible under existing law.

* * *

This concludes my prepared remarks. I would be happy to respond to your questions.

[T]REASURY NEWS

[Depa]rtment of the Treasury • Washington, D.C. • Telephone 566-2041

TREASURY ADVISORY
April 23, 1985

CONTACT: Brien Benson
(202) 566-2041

Paul Allan Schott Resigns

Paul Allan Schott has resigned as Treasury Department Assistant General Counsel for Banking and Finance, to take a position with the Washington, DC law firm of Barnett, Yingling and Shay, where he will concentrate on banking and financial services law.

During his 1979-1985 tenure at Treasury Schott specialized in deregulation of the banking industry, including drafting the Administration's banking bill. His other responsibilities included phaseout of deposit interest rate ceilings, thrift industry problems, securities activities of banks, interstate branching and bank holding company acquisitions, and consolidation of bank regulatory agencies.

Schott served as a Senior Attorney at the Federal Reserve Board from 1973 to 1979, and holds an L.L.M. from Georgetown University Law Center and a J.D. from Boston University School of Law.

Walter T. Eccard will serve as Acting Assistant Counsel for Banking and Finance until a permanent replacement is found.

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R-104

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.

April 23, 1985

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,700 million, to be issued May 2, 1985. This offering will not provide new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,655 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, April 29, 1985. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,850 million, representing an additional amount of bills dated January 31, 1985, and to mature August 1, 1985 (CUSIP No. 912794 HU 1), currently outstanding in the amount of $7,025 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $6,850 million, representing an additional amount of bills dated November 1, 1984, and to mature October 31, 1985 (CUSIP No. 912794 HN 7), currently outstanding in the amount of $8,259 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 2, 1985. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,493 million as agents for foreign and international monetary authorities, and $2,417 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF
THE HONORABLE
JAMES W. CONROW
ACTING ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS OF THE
COMMITTEE ON APPROPRIATIONS
U.S. HOUSE OF REPRESENTATIVES
APRIL 25, 1985

Mr. Chairman and Members of the Committee:

Thank you for the invitation to appear before your Committee today. I realize the difficulty in scheduling Treasury's testimony this year, and I sincerely appreciate your willingness to allow Treasury to present testimony today on the President's supplemental budget request for the Multilateral Development Banks (MDBs) for fiscal year 1985. As you know, Secretary Baker will discuss the Administration's fiscal year 1986 budget request on May 16.

U.S. Unfunded Replenishment Commitments

The Administration's FY 1985 supplemental request reflects our determination to honor United States' commitments to the institutions, the other donor countries, and most importantly, to the people of the developing countries themselves -- commitments for the most part negotiated by this Administration.

I am well aware, Mr. Chairman, of your views on budgetary supplementals in the absence of an emergency. But I believe our unfunded replenishment commitments are truly creating a very difficult situation for MDB lending programs. Currently, the United States' funding shortfall of $91 million in the Asian Development Fund (ADF) has, because of a cost sharing mechanism, led to total reductions in donor contributions of about $250 million. Without our requested funds, the ADF will be forced to make contingent loan commitments, which prevent the institution from finalizing its loan agreements.

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The Inter-American Development Bank (IDB) is in a worse situation. Because charter provisions provide the United States with 34.5 percent of the IDB voting power, the Bank cannot accept subscriptions from others that would push us below this level. The current U.S. shortfall in subscriptions is $40 million paid-in capital and $849 million in callable capital. Based on the 34.5 percent criterion, the IDB now has a cumulative shortfall in convertible currencies of close to $1.2 billion in lending authority -- and it could increase to nearly $2 billion if the U.S. shortfall continues until October. This has forced the IDB to stop its lending program. It can only make contingent commitments until we provide our subscription shortfall.

The replenishment of the IDB's soft loan window, the Fund for Special Operations (FSO), also contains a cost sharing mechanism. Our shortfall of $72.5 million has resulted in a total shortfall of around $175 million.

The first installment for the Inter-American Investment Corporation (IIC) remains incomplete and detracts from our efforts to urge others to accelerate ratification. To continue to demonstrate the leadership exercised previously in helping to establish the IIC, the United States needs to quickly eliminate the $3 million shortage.

The $400 million shortfall in subscription's to the World Bank's 1981-86 General Capital Increase (GCI) has already stretched out the U.S. contribution over a seven-year period. Failure to meet even this extended schedule could further erode U.S. credibility in this important institution. The difficult development and adjustment problems now facing the developing countries underscores the importance of the efforts being made by the World Bank.

I believe that consistent shortfalls can cause serious damage to our relations with other member countries, and with the institutions themselves. More importantly, they have a negative impact on the people of the developing countries who are the beneficiaries of these institutions. On the basis of our extensive consultations with the Congress, including this Committee, we entered into commitments we believed the United States would be able to honor. We now find ourselves unable to fulfill the obligations we agreed to. Frankly, this is not good government, and, does not speak well for the United States. Secretary Baker has stated that it is totally unbecoming and unreasonable for the world's most powerful nation to refuse to honor international commitments made in good faith, and after full consultation between the Executive and the Legislative Branches of government.

The Fiscal Year 1985 Supplemental Budget Request

We are requesting $236.7 million in budget authority and $1,219.0 million under program limitations for callable capital subscriptions as a fiscal year 1985 supplemental.

International Bank for Reconstruction and Development (IBRD)

The Administration is seeking a fiscal year 1985 supplemental request of $30.0 million in budget authority for paid-in capital and $370.0 million under program limitations for callable capital to complete the fourth of six installments for the U.S. share of the 1981 GCI of the World Bank.

The Administration continues to believe that the IBRD should play a prominent role in the longer-term development programs of its borrowers. Eliminating the U.S. shortfall to the World Bank is the most concrete way to demonstrate our support.

Inter-American Development Bank (IDB)

For the IDB, the Administration is seeking $40.0 million in budget authority and $849.0 million under program limitations for subscriptions to complete the second of four installments to the 1983 capital increase of the IDB.

Fund for Special Operations (FSO)

The Administration is seeking $72.5 million for the second of four installments for the 1983 replenishment.

The FSO replenishment is designed to address the long term development needs of the poorest countries, primarily in Central America and the Caribbean. As a result of U.S. unfunded commitments to the FSO, other countries are also holding back on their payments.

Inter-American Investment Corporation (IIC)

For the IIC, the Administration is requesting $3 million to complete the first of four installments for the initial U.S. subscription to the IIC.

The Administration strongly supported establishing the IIC as a practical means of enhancing the capacity of the IDB to aid the private sector in borrowing countries.

Asian Development Fund (ADF)

The Administration is seeking $28.2 million to complete U.S. contributions to the first replenishment and $63 million to complete the second of four installments to the third replenishment.

The ADF has supported well designed and effective development projects in some of the poorest countries in the world. U.S. support benefits the people of such countries as Pakistan, Bangladesh, and Sri Lanka as well as many of the strategic island countries in the Southern Pacific.

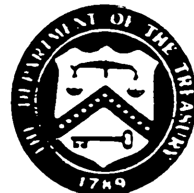
Conclusion

In conclusion, Mr. Chairman, I want to emphasize this Administration's commitment and full support for the MDBs. In this context, I reiterate the importance of the supplemental request for contributions and subscriptions that we have requested.

As you know, Mr. Chairman, the Administration made an earnest effort to consult closely with the concerned members of the Congress in conducting our 1982 Assessment of the MDBs and in negotiating the replenishments on the basis of the Assessment's guidelines. Moreover, President Reagan, in various international fora, has repeatedly stressed U.S. commitment to these institutions.

Our inability to honor commitments seriously damages the Administration's negotiating position for future MDB replenishments. This inability also tends to fragment all our cooperative endeavors, such as influencing the MDBs to push for policy reforms geared to increasing economic efficiency, and fostering broad opportunities which will enable all strata of the population to benefit from economic development. Now, we urge your support for the Administration's MDB request so that the people for whom these institutions were created to serve will benefit.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 a.m., E.S.T.
April 24, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
WAYS AND MEANS COMMITTEE
OF THE HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Treasury Department on the application of the imputed interest and original issue discount ("OID") rules to seller-financed sales of property. We are pleased to participate in the Committee's reexamination of these provisions in light of the expiration at the end of June of temporary rules contained in P.L. 98-612.

The Tax Reform Act of 1984 (the "1984 Act") refined the imputed interest rules of prior law to require that taxpayers (i) determine whether adequate interest is stated in a contract for the sale of property by testing against interest rates which more closely approximate market interest rates, and (ii) allocate interest (including imputed interest) to the periods to which it relates and take the interest into account for that period. Taken together, these changes provide for the proper economic treatment of deferred payment obligations arising in connection with the sale or exchange of property. The new rules will largely prevent the abuses which arose prior to the 1984 Act, including mismatching of income and deduction, overstatement of tax basis and investment tax credit ("ITC") and accelerated cost recovery system ("ACRS") allowances and the conversion of ordinary income into capital gain taxed on a deferred basis.

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Although the Treasury Department believes the 1984 Act rules provide the proper tax treatment for sales and exchanges of property, we support efforts to provide simpler rules for "small" transactions. In view of the expiration of the temporary rules contained in P.L. 98-612, I will discuss the application of the imputed interest and OID rules to transactions involving relatively small amounts. I will then address certain improvements that we believe can be made in these rules for larger transactions. Finally, I will comment on the rules relating to transactions where an existing debt obligation is assumed or property is taken subject to an obligation.

I

BACKGROUND

Congress substantially modified the imputed interest and OID rules in the 1984 Act. As this Committee considers the appropriate permanent rules for seller-financed sales of property, it is important to review both the prior law rules and the reasons for the 1984 Act amendments.

1. Rules Prior to the 1984 Act

Beginning in 1969, holders of publicly-traded discount obligations or obligations issued for publicly traded property were required to include and issuers were able to deduct OID over the term of the obligation, without regard to whether the parties were on the cash or accrual method for other items of income and deduction. This treatment of original issue discount is based on two premises. First, the rules recognize that original issue discount represents interest that will accrue, but not be paid currently during the term of the obligation; this deferral is the economic equivalent of the borrower paying the interest which accrues currently with additional funds borrowed from the lender. Second, the requirement that the issuer and holder of an original issue discount obligation report original discount obligation on the accrual method ensures consistent accounting. Without such a rule, the parties could mismatch income and deductions.

The prior law OID rules, however, did not apply to obligations issued by individuals or to obligations issued in exchange for non-publicly traded property. Thus, transactions involving the purchase of real estate or non-publicly traded personal property in which there was seller financing were outside the scope of the original issue discount rules even if the financing permitted interest to accrue without being paid currently.

Deferred payment obligations issued in exchange for non-publicly traded property, including obligations issued by individuals, however, were subject to section 483. Section 483

required the parties to state a minimum rate of interest (under prior law, 9 percent simple interest) or interest would be imputed at a higher rate (10 percent compounded semiannually). Section 483 provided a maximum test rate of 6 percent and an imputation rate of 7 percent for related party real estate transactions involving $500,000 or less.

2. Reasons for Change

Limited Scope of OID Rules

Under prior law, the OID rules did not apply to deferred interest obligations issued in connection with the purchase of real estate or non-publicly traded personal property (such as machinery), or to such obligations issued by individuals. In these situations, tax avoidance opportunities resulted from the fact that interest would accrue each year, but would not be paid until maturity. The issuer of the obligation, if using the accrual method of accounting, could claim annual interest deductions while cash method holders deferred inclusion of the discount until maturity.

The ability to mismatch income and deductions for OID formed the basis for numerous real estate and other tax shelter offerings. The revenue loss from these tax shelter offerings was significant and increasing dramatically as this structuring technique became known and used widely in transactions involving seller-financing. An example illustrates the magnitude of the revenue loss from a typical transaction: A $5 million obligation bearing interest at 12.5 percent, compounded annually, and payable in a lump sum after 20 years is exchanged for property. An accrual method obligor in the 50 percent tax bracket would claim interest deductions over the term of the obligation having a present value of $5.6 million. Because the cash method obligee would defer recognition of interest income until maturity, the present value of the tax paid by the obligee in the 50 percent tax bracket is $2.3 million. Thus, the revenue loss from one $5 million transaction from the mismatching of interest income and deduction is approximately $3.3 million on a present value basis. Of course, for larger transactions, the revenue loss would be proportionately larger (e.g., $13.1 million for a $20 million transaction).

In addition to the asymmetrical treatment of issuers and holders, discount bonds issued in tax shelter transactions of the type described above frequently embodied a noneconomic computation of interest (i.e., simple interest payable on a deferred basis). Reporting interest on a simple interest basis accelerates interest deductions by ignoring the compounding of interest on deferred but unpaid interest; thus, interest is not properly allocated to the period in which it actually accrues. Cash method holders of the obligations are, of course,

indifferent to these timing concerns because they defer inclusion until maturity. Although the use of noneconomic interest calculations was largely proscribed by Rev. Rul. 83-84, 1983-1 C.B. 97, we understand that several tax shelter offerings made prior to the 1984 Act took positions inconsistent with this ruling.

Deficiencies of Section 483

The tax law provides for different treatment of interest and principal of debt obligations given in exchange for property. In addition, other tax consequences flow from the characterization of payments as either interest or principal, such as the seller's amount realized and the buyer's tax basis in the acquired property. Section 483 was originally enacted to ensure that parties properly characterized as interest or principal amounts paid pursuant to obligations given in exchange for property.

Without interest imputation rules such as those provided in section 483, whenever a debt obligation is given in exchange for property, the parties would have the flexibility to adjust the rate of interest charged and the principal amount of the obligation so as to produce an optimal tax result without altering the underlying economic transaction. If these distortions were permitted, a seller could convert ordinary interest income into capital gain (taxable on a deferred basis under the installment sale rules) or gain that might be deferred indefinitely where a residence is sold. In the case of a buyer, the tax basis of the acquired asset would be overstated and excess ACRS allowance and ITC would be claimed.

An overstatement of principal and understatement of interest may also occur, and often does occur, even when the parties are not purposefully attempting to avoid taxes. For example, suppose a taxpayer has a piece of property which he genuinely believes is worth $1 million. He wishes to sell the property at this price but is unable to find a willing buyer. In order to move the property, the taxpayer decides (for nontax reasons) not to lower the purchase price but to offer seller financing at a below-market rate for a portion of the purchase price. This enables the taxpayer to close the sale transaction.

In this situation, the fact that the seller had to offer below-market financing to sell the property indicates that the property was not worth $1 million. Thus, even if tax avoidance was not the goal of either party to the sale, the seller has converted ordinary interest income into capital gain and the buyer has obtained an overstated basis.

This tax advantage is never available where a third-party lender finances the purchase of property (unless the seller makes a payment to the lender to "buy down" the buyer's interest rate).

In such cases, the interest rate for the borrowing and the purchase price for the property are independently fixed at arm's length.

Historically, the section 483 test rates have been adjusted only infrequently, and have often been at rates considerably below market interest rates. To the extent that the test rate provided under section 483 is less than a market rate of interest, the buyer and seller may improperly characterize a portion of deferred payments as principal and understate their tax liability. Thus, a below-market test rate effectively provides a tax subsidy for seller-financed sales of property.

Prior to the 1984 Act, we became aware of a substantial -- and rapidly increasing -- number of transactions that exploited the below-market interest test rate and the noneconomic simple interest computation provided under section 483. In one case brought to our attention, a tax basis of more than five times the established fair market value of the property was claimed. Under a proper economic analysis, the "excess basis" -- i.e., the amounts payable under the obligation in excess of the fair market value of the acquired property -- represents interest and should be deductible only as it accrues over the life of the obligation. However, by virtue of the defective operation of section 483, taxpayers claimed that the excess was transformed into inflated ITC and ACRS allowances which had a materially higher present value than the interest deductions.

3. 1984 Act Changes

These abuses prompted the Treasury Department to propose a number of changes to section 483 and the OID rules. Congress adopted these proposed changes as part of the 1984 Act.

Section 1274

For transactions involving deferred payments for the sale of non-publicly traded property, the 1984 Act establishes safe harbor interest rates based on the term of the obligation to test whether the obligation states adequate interest. If the parties to a sale or exchange of non-publicly traded property involving deferred payments fail to state adequate interest, interest is imputed at a higher rate. The safe harbor test rate is 110 percent of the "applicable Federal rate" and the rate at which interest is imputed is 120 percent of the applicable Federal rate. The applicable Federal rates ("AFR") are based on average market yields on outstanding Treasury obligations of comparable maturity. The Treasury is to determine the rates for Treasury obligations with maturities of 3 years or less (the "Federal short-term rate"), over 3 years but less than 9 years (the "Federal mid-term rate") and over 9 years (the "Federal long-term rate").

The 1984 Act also expands the scope of the OID rules. After December 31, 1984, obligations issued by individuals and obligations issued for non-publicly traded property which provide for deferred interest or which fail to state adequate interest are subject to the OID rules.

The section 1274 rules embody two concepts: (i) a test rate designed to approximate a market rate of interest and (ii) OID rules requiring the parties to take into account, on the accrual method, imputed interest (where adequate interest is not stated) or stated interest (where adequate interest is stated, but is not paid currently).

In recognition that the new rules impose a greater degree of complexity than the prior law rules, Congress provided several exceptions for routine transactions and transactions not involving large amounts of money. Thus, sales of principal residences, certain sales of farms for less than $1 million and any sales involving total payments of $250,000 or less are not subject to section 1274.

Changes to Section 483

The application of section 483 was limited to deferred payment transactions involving sales or exchanges of property falling within one of the exceptions to the OID rules. The existence of unstated interest is tested with reference to the applicable Federal rates established under the OID rules. Where imputed interest is present, however, it will be taken into account only as payments are made (rather than under an accrual method, as provided in section 1274). Thus, under section 483, "principal" payments are recharacterized as interest to the extent that imputed interest has accrued but has not been paid through the time of payment.

In cases involving the sale or exchange of a principal residence (to the extent of the first $250,000 of the cost of the residence) or farmland costing less than $1 million, the 1984 Act provided that the test rate previously applicable under section 483 would apply. Thus, the existence of unstated interest would be determined by reference to a 9 percent test rate.

4. Public Law 98-612

After passage of the 1984 Act, a number of concerns were raised regarding the impact of the changes described above on relatively small transactions. To address some of these concerns temporarily and permit the Congress to reexamine the OID and imputed interest rules in this session, Congress passed P.L. 98-612 in October 1984 which contained temporary and permanent rules relating to seller-financed sales of property. Most

importantly, P.L. 98-612 provided that for sales or exchanges of property (other than new section 38 property) occurring prior to July 1, 1985, the test rate is 9 percent (compounded semiannually) on up to the first $2 million of seller financing. For transactions involving more than $2 million of total financing, the test rate is a weighted average of 9 percent and 110 percent of the applicable Federal rate.

P.L. 98-612 also provided that sections 1274 and 483 generally apply to assumptions of existing obligations in connection with sales or exchanges of property or taking property subject to an existing obligation. Congress, however, specifically exempted from the scope of sections 483 and 1274 assumptions of obligations originally issued on or before October 15, 1984, in transactions where the sales price does not exceed $100 million. P.L. 98-612 also provided exemptions from the rule on assumptions generally for transactions involving (i) personal residences, (ii) property used in the active conduct of the trade or business of farming, and (iii) property (other than new section 38 property) used in an active trade or business.

II

SMALL TRANSACTIONS

Although the principles underlying the OID and imputed interest rules are equally applicable to all seller-financing transactions, we recognize that these rules impose additional burdens in planning sales transactions and that these burdens weigh proportionately more heavily on small transactions. Therefore, we agree it is appropriate to consider rules that would simplify the system for small transactions.

We feel obliged to point out to the Committee, however, that any system that provides different rules for small and large transactions must also describe in what circumstances transactions will be aggregated for purposes of ascertaining whether the small transaction rules should apply. Without clearly defined aggregation rules, the large transaction rules could easily be avoided. For example, a seller of a single piece of property worth $5 million cannot be permitted to benefit from the small transaction rules by selling five separate 20% interests in the property to the same buyer in five transactions taking place at substantially the same time. While this type of abuse can be dealt with easily enough, other cases involving a single seller and multiple buyers or multiple sellers and a single buyer will present significant problems. While the difficulties of formulating fair and workable aggregation rules are not insubstantial, we believe that these problems are outweighed by the need to provide simpler rules for small transactions.

1. Fixed Test Rate

Prior to the 1984 Act, the prevailing test rate was widely known and individuals could structure routine transactions without consulting tax periodicals or a tax professional to determine the current applicable Federal rates. To continue this system for relatively small transactions, we would support the application of a fixed lower test rate. This rate would be adjusted only to reflect significant long-term shifts in market interest rates.

We suggest that the lower rate be fixed initially at 9 percent, based on compounding at least annually. This fixed rate would provide a degree of certainty and simplicity for small transactions by removing the need to refer to the applicable Federal rate, which changes frequently. To give some effect to shifts in market rates, however, this fixed rate might automatically adjust when the applicable Federal rates shift very substantially and remain at the new levels for a relatively long time period. At the end of this time period, the small transaction rate could be adjusted to, for example, the nearest whole percentage to 80 percent of the current monthly Federal mid-term rate. Of course, if the test rate applicable to large transactions actually fell below the fixed small transaction rate, the parties would be permitted to use the lower test rate.

A fixed rate for small transactions, adjusted infrequently is far preferable to a floating rate, such as a fixed percentage of the applicable Federal rate. Although such a system would always result in a below-market test rate for small transactions, the floating rate would do nothing to eliminate the uncertainty for transactions involving relatively small amounts of money since the parties would still be required to consult current market interest rates simply to structure such transactions.

2. Definition of Small Transaction

The distinction between large and small transactions can be based on either the purchase price of the property or on the amount of seller financing involved. If the purchase price of the property is the basis for the distinction, we suggest that the special rule for small transactions be limited to transactions with a purchase price of $2 million or less. For this purpose, purchase price would include cash and the fair market value of any property transferred to the seller, as well as the stated principal amount of any financing. Alternatively, if the Committee prefers to continue to base the distinction between large and small transactions on the amount of seller financing, we suggest that the special rule for small transactions be limited to transactions where the amount of seller financing does not exceed $1 million.

For transactions above whichever of these thresholds is chosen, the parties generally are sufficiently sophisticated to be aware of current market interest rates, and we are not persuaded that the additional complexity involved in consulting current applicable Federal rates is burdensome when compared to the other complexities that inevitably accompany a sale of an expensive property. When a below-market interest rate is charged in such large transactions, the parties should be fully aware of the relationship between the purchase price and the interest rate charged, as well as the resulting tax consequences.

3. Application of OID Rules to Small Transactions

Some have suggested that parties to a small transaction should have the option to elect cash accounting for both parties in lieu of the OID rules. In evaluating this option, it is important to bear in mind that the OID rules apply only if the parties to a sales transaction do not provide adequate stated interest or if the transaction does not call for interest to be paid currently. Since virtually all taxpayers will provide at least the 9 percent interest required to avoid imputed interest, this option is important only in situations where the parties provide for deferred interest.

We acknowledge that an election to report deferred payments on the cash method may be simpler for the parties than the OID rules. However, the existence of two separate accounting systems for small and large transactions also would create new complexities. For example, assume that property is sold under the small transaction rule and the parties elect the cash method; subsequently, the property is resold in a transaction which is subject to the OID rules and the original obligation is assumed. In this situation, may the subsequent purchaser accrue interest deductions currently while the original seller continues to report interest income only as received? Alternatively, assume the seller of the property disposes of the buyer's obligation to an accrual basis taxpayer. Is the subsequent holder entitled to use the seller's cash matching election? Rules that would have to be provided to deal with such problems would make the cash method election potentially very complicated.

A cash-matching election also involves potential for abuse. For example, an owner of property could sell to a tax-exempt intermediary for a note calling for deferred interest payments, with the parties electing the cash method. The tax-exempt intermediary could then sell to the intended buyer on the same terms, with the buyer and the intermediary not electing the cash method. The buyer could then report current interest deductions under the OID rules, while the seller would have no current interest income inclusion. The intermediary would use its tax exemption to insulate itself from adverse consequences of the OID interest inclusions.

Although a rule could be designed to address this particular arrangement, we are not optimistic that every type of transaction which is similar to this arrangement and exploits differences in marginal tax rates could be stopped. If effective anti-abuse rules are not developed to address all schemes structured to avoid the requirement that the parties to a deferred payment sale of property account consistently for the interest element in the transaction, one of the major abuses addressed in the 1984 Act, the potential for mismatching income and deductions, will remain.

In view of the inevitable complexity involved with separate accounting systems for small and large transactions and the potential for abuse, we would urge the Committee not to adopt a special accounting rule for small transactions.

4. Application of Small Transaction Rules to Dealers

We suggest that any special rules for small transactions apply only to casual sales of property. Special rules for small transactions can be justified only on the ground that the generally applicable imputed interest and OID rules are too complex when relatively unsophisticated parties are buying or selling property. Dealers that regularly transact for the sale or purchase of property are sufficiently sophisticated to be aware of current market interest rates. Indeed, many dealers in residential real property are New York Stock Exchange-listed firms that engage in thousands of sales annually. These taxpayers have little basis for claiming the new imputed interest and OID rules are overly complex. Moreover, exempting dealers from the small transaction rule would obviate many of the more difficult aggregation issues referred to earlier.

5. No Special Rule for Sales of Certain Types of Property

A broadly-based special rule for small transactions would provide a degree of certainty for parties to routine sale transactions and can be justified on the grounds of simplicity. This rule would apply sales of all types of property including, sales of small businesses, residences and farms. Therefore, we oppose providing additional exceptions to these rules for transactions in these or other special types of property. Such exemptions are unnecessary in light of the small transaction rule and constitute a subsidy for transactions in such types of property. Moreover, each additional exception adds complexity to the Internal Revenue Code and to the regulations as rules must be formulated defining the scope of each exception, identifying and preventing abuses, and regarding the interrelationship of the various exceptions.

If a general exception for small transactions of all types is adopted, the existing special rules that provide lower rates for transactions in certain types of property are no longer needed.

Thus, we would support the repeal of the existing special rules for certain types of transactions, including the rules relating to sales of principal residences, sales of farms and sales of land between related parties.

III

SUGGESTED CHANGES TO THE BASIC RULE

Although we believe that the rules enacted in the 1984 Act generally provide for the correct treatment of seller-financed sales of property, we think that a number of improvements can be made in the existing statutory structure. I turn now to these matters.

1. Selecting the Appropriate Interest Rate Index

As I have already stated, if one party sells a piece of property to another in a transaction that calls for one or more deferred payments, and if the deferred payments do not include an interest charge at a market rate of interest, the parties have the opportunity to overstate the purchase price for the property. The question then arises: What constitutes a "market rate of interest"? The current statute answers this question by reference to the rate at which the Federal Government borrows money, taking into account (to a limited extent) the term of the obligation.

We continue to believe that an interest rate index based on the yields on United States obligations is the most reliable and appropriate indicator of market rates of interest, for the following reasons:

- The Federal borrowing rate accurately reflects trends in the market rate at which a given borrower could obtain funds from an unrelated lender.

- A rate based on the yield of U.S. Government obligations is not subject to manipulation.

- U.S. Government rates are readily available; no data need be gathered from third party sources.

- There is a large volume of U.S. obligations with remaining maturities ranging from 30 days to 30 years. This assures a statistically valid data base from which to compute the market interest rate index.

The imputed interest rules provide that the applicable Federal rate is multiplied by a factor of 110 percent to compute the appropriate test rate. This multiple reflects that even the

most creditworthy borrower will not be able to borrow at a rate as low as the Federal Government pays on its obligations. We support retention of the 110 percent factor applied to the applicable Federal rates to determine the testing rate for whether a transaction has adequate stated interest. The factor is not punitive; in many arm's-length lending transactions the market rate of interest would be 130 percent, 140 percent or more of the applicable Federal rate, due to the creditworthiness of the borrower.

Attached to this testimony are four charts which show the relationship between private and Federal Government interest rates over the course of the last eight years. Chart 1 compares the FHA mortgage rate to a Federal long-term composite rate.1/ This chart shows a close relationship between the two indices during all periods, with the FHA rate consistently above the Government rate.

Chart 2 shows the ratio of the FHA index to the long-term Government index. In other words, this chart expresses the FHA rate as a percentage of the long-term Government rate. At no time during this period did this percentage ever drop below 110 percent and at times was over 130 percent. This relationship indicates that a test rate based on 110 percent of a Federal long-term borrowing rate is entirely appropriate.

Charts 3 and 4 provide the analogous comparisons between the average prime lending rate and the average yield on new issues of 1-year Government securities. Again the correlation between the two averages is extremely high. Chart 4 shows that the prime rate was always at least 110 percent of the 1-year Government rate.2/

1/ The FHA mortgage rate is the rate charged to home buyers for FHA-insured mortgages. The Federal long-term composite rate index is based on yields of Government bonds with constant maturities of 10 years or more. The latter index is very similar to the Federal long-term rate of current law and was chosen in lieu of the Federal long-term rate because past data for the latter index are not readily available. Both indices are compiled from data published in Domestic Financial Statistics, a publication of the Federal Reserve Board.

2/ The data on the prime rate and the 1-year Government rate on new issues are also taken from Domestic Financial Statistics. Private borrowing rates are quite likely to exceed the prime rate, especially on lending transactions of more than one year (but not more than 3 years). Also, the 1-year Government rate on new issues will not be identical to the Federal short-term rate since the latter index takes into account all maturities of 3 years or less on all outstanding issues.

We are well aware that legislation has been introduced (with the support of a number of the groups that will be testifying before this Committee later today) to lower the test rate to 80% of the applicable Federal rate. We urge this Committee not to adopt such change. Allowing taxpayers to state interest rates as low as 80% of the AFR would allow very substantial overstatements of true purchase price in sales of property calling for deferred payments. This overstated purchase price benefits both the seller (in the form of a conversion of ordinary interest income into capital gain) and the buyer (by converting interest deductions into depreciable basis that can be written off on an accelerated basis).

At current interest rates, a shift to a test rate of 80 percent of the applicable Federal rate would allow a basis overstatement in any sales transaction of more than 30 percent, assuming a purchase money loan for the entire sales price with a term of 30 years and level monthly payments over the term of the loan. For example, a building having a value of $10 million could be sold for over $13 million. In the case of loans calling for a single payment of principal and interest at maturity, the potential overstatement is far greater. For example, if the debt instrument described above called for a single payment at maturity, the same $10 million building could be sold for a purchase price of over $27 million.

For the tax law to permit distortions of this magnitude would be a substantial step in the wrong direction. A system using a test rate of 80 percent of the applicable Federal rate would present the worst of two worlds; the complexities of a floating test rate would be retained while one of the two major abuses that led to enactment of the 1984 Act provisions (basis overstatement) would remain unchecked.

2. <u>No Blended Rate for Larger Transactions</u>

We do not believe that the test rate for small transactions should apply to any portion of the borrowed amount on a transaction above the small-transaction threshold. Our primary reason for opposing the "blended rate" approach of P.L. 98-612 is that there is no reason to provide a test rate which is below a market interest rate for transactions in excess of the threshold amount. The sole justification for the 9 percent rate for small transactions is that it is a fixed, well-known rate that parties can use without reference to floating rates published periodically. This justification disappears as soon as the fixed rate is to be blended with a higher floating rate.

The blended rate also adds a significant amount of complexity to the imputed interest rules. For example, if a small transaction threshold based on purchase price is chosen, parties

negotiating a sale of property for a purchase price in excess of the threshold amount will not know the minimum interest rate that needs to be charged because that rate will depend on the purchase price. Since the purchase price will depend in turn on the interest rate to be charged, the parties will be faced with a difficult interrelated computation that can be solved only through the use of sophisticated mathematical techniques. (Similar problems would arise with a threshold based on seller financing.)

Finally, a blended rate for transactions in excess of $1 million is not necessary to avoid a "cliff", that is, a dramatic difference between the tax consequences of a sale of property with a value just below the threshold amount and the consequences of a sale of property worth just over the threshold amount. In fact, a specific dollar limit based on either the stated sales price or the amount of seller financing essentially operates as a gradual phase out of the lower rate.

To see why this is so, one must bear in mind that the right to state a 9 percent interest rate when prevailing market rates are higher allows parties to overstate the purchase price of the property sold. For example, if the prevailing market interest rate is 12 percent and the property is to be paid for in ten equal annual installments, the purchase price of the property is overstated by a factor of approximately 13.6 percent. Thus, a sale of property for a $1 million note with interest a 9 percent on these terms would indicate a true value of the property of approximately $880,000. For property having a value of more than $880,000 but less than $1 million, if the small transaction threshold were $1 million of seller financing, the parties would in each case state a purchase price of $1 million but would charge an interest rate between 9 percent and a market rate to achieve the correct economic result. Thus, the small transaction rule is advantageous until the rate that must be charged equals the rate applicable to large transactions.

The following table illustrates the correlation between the value of property and the interest rate that would be charged if the stated principal amount is $1 million.

Actual Value	Stated Sales Price	Interest Rate
$ 880,418.26	$1,000,000	9.0%
899,889.28	1,000,000	9.5%
919,547.78	1,000,000	10.0%
939,390.94	1,000,000	10.5%
959,415.94	1,000,000	11.0%
979,619.91	1,000,000	11.5%
1,000,000.00	1,000,000	12.0%

We recognize that, notwithstanding the above analysis, a perception remains that a cliff exists between the small transaction and large transaction rules. If this Committee wishes to address this perceived problem, we would recommend a simple phase-out of the benefit of the 9 percent rate for transactions with a sale price between $2 million and $3 million (or seller financing between $1 million and $2 million) rather than a blended rate for all large transactions. This would simplify the system for larger transactions and would have the added benefit of limiting the revenue loss from the 9 percent subsidy rate.

3. Conforming the Imputed Interest Rate to the Testing Rate

Under current law, if the parties to a sales transaction do not provide for interest at a rate at least equal to the safe harbor test rate, interest will be imputed at a higher imputed rate. For sales involving total financing $2 million, the test rate is 9 percent and the imputed rate is 10 percent. To the extent the total financing exceeds $2 million, the test rate is 110% of the AFR and the imputed rate is 120% of the AFR.

This feature of current law is a carryover from old section 483, under which interest of at least 9 percent had to be stated to avoid interest being imputed at 10 percent. The original reasons for having different test rates and imputed rates, as well as the reasons for carrying this aspect of old section 483 forward in the 1984 Act, are not entirely clear.

Whatever these reasons, Treasury believes that the system could be made simpler and fairer by setting both the test rate and the imputed interest rate at 110% of the AFR for large transactions and by setting both these rates at 9 percent for small transactions. The system would be simpler because fewer rates would have to be computed, published and assimilated by taxpayers and their advisers. The system would be fairer because parties would not be penalized for failing to provide the minimum interest rate required; the tax law would simply recharacterize the transaction as if this minimum interest rate had been provided.

4. Frequency of Determination -- Semiannual or Monthly?

The 1984 Act calls for semiannual redeterminations of the applicable Federal rates. Soon after enactment of the 1984 Act, however, it became apparent that if taxpayers are to be required to state a market rate of interest, the system cannot work if the test rate is substantially out of date.

The 1984 statute calls for rates that are, on the average, 9 months out of date. Moreover, transactions taking place at the end of a semiannual period would be governed by a test rate based

on interest rates in effect as much as 15 months earlier. For example, a transaction taking place on June 30, 1985 would be governed by a test rate determined in part by reference to yields on U.S. obligations during the month of April 1984.

As an interim measure, Treasury decided to address this "time lag" problem by providing in temporary regulations an alternate calculation of the applicable Federal rates, based on monthly rather than semiannual recomputations. This substantially reduces (but does not eliminate entirely) the time lag problem. The monthly rates were provided as an alternative to the statutory semiannual rates; the latter rates remain available in the event they are lower.

In moving from a semiannual to a monthly redetermination of the applicable Federal rates, we recognized that to some extent we were making it more difficult to negotiate and plan sales transactions. To ease this problem, we provided an additional special rule, allowing taxpayers in a given month to use the rates in effect for the preceding and the second preceding month (in addition to the current month's rates). This rule assures that, once a set of monthly rates is published, taxpayers can be assured that the applicable Federal rates will be no higher than those rates during a three-month period.

We believe that the system of Federal rates computed on a monthly basis contained in the recently released temporary regulations strikes a reasonable balance between the need to reduce the time lag problem and the need to provide some planning stability to taxpayers. We urge this Committee to adopt the system of monthly rates contained in the recent temporary regulation in lieu of the statutory semiannual system. We see no need to continue a dual system, especially since the statutory rates can result in substantial overstatements of basis in times of rising interest rates. More significantly, codifying the monthly approach of the regulations as the exclusive means for determining the applicable Federal rates would be far simpler than the current dual system.

5. Limiting the Variation in the Applicable Federal Rate

It has been suggested that, whatever index is chosen for determining market interest rates, the index should not be permitted to increase by more than a fixed number of percentage or basis points from one period to the next. For example, it has been suggested that the applicable Federal rates not be permitted to increase by more than 10 basis points (0.1%) from one month to the next. This proposal is sometimes referred to as placing a "governor" on the applicable Federal rates.

As the charts attached to this testimony indicate, when Federal borrowing rates increase or decrease significantly, market interest rates in private lending transactions faithfully

reflect the increase or decrease. This applies to short-lived peaks and valleys as well as long-term trends. To deny this reality by placing a governor on the applicable Federal rates would simply give taxpayers an opportunity to understate true borrowing costs and overstate basis until the applicable Federal rates had time to catch up with the change in the market rates. Therefore, we believe that placing a governor on the applicable Federal rates is both unnecessary and unwise.

6. <u>Alternate Methods of Proving Adequate Stated Interest</u>

As noted above, the function of the applicable Federal rates is to serve as an objective indicator of current market rates of interest for short-term, mid-term and long-term lending transactions. However, even with a shift from a semiannual to a monthly redetermination of the applicable Federal rates, some time lag remains in the system. In times of rapidly falling interest rates, the market interest rate actually in effect at the end of a given month may be significantly below the applicable Federal rate for that month. This time lag is inevitable in any system under which test rates are computed and published on a periodic basis.

A related problem arises from the classification of all lending transactions into short-term, mid-term and long-term for purposes of determining the applicable Federal rate. If an actual transaction has a relatively short maturity among transactions within its class (for example, a 1-year loan, a 4-year loan or a 10-year loan), the use of an average yield for all maturities falling within that class may unfairly prejudice the relatively short maturities.

To take care of these and similar problems, we do not believe it is appropriate to attempt to make specific statutory refinements in the applicable Federal rates (such as weekly adjustments in the rate or narrower classifications of obligations by maturity). Such refinements would unduly complicate the system with only a minimal gain in accuracy. Instead, we think that taxpayers should be given certain opportunities to demonstrate that their transaction contains adequate stated interest other than by reference to the applicable Federal rate.

First, we believe that taxpayers should be permitted to compute and use indices based on the same principles as the applicable Federal rate but with greater accuracy than the published rates. For example, if a taxpayer selling property with the payment of principal due in 10 years could show that 110 percent of the average yield on 10-year Treasury securities was less than the interest rate provided in the sales transaction, the transaction would be treated as having adequate stated interest. Information of this type is readily available in weekly and monthly publications of the Federal Reserve Board.

Second, if a taxpayer can demonstrate that third-party financing could have been obtained by the buyer on the same terms as provided in the seller financing, the debt will be considered to have adequate stated interest. The taxpayer would have to show that this financing was available to a broad segment of the general public and that the buyer's creditworthiness would have allowed it to qualify for this financing; a mere letter or affidavit from a bank stating that it would have been willing to provide the funds on the stated terms would not be sufficient if no such loans were actually made on those terms.

Finally, sellers of fungible units of personal property on the installment basis should be given the opportunity to demonstrate that the financing contained adequate stated interest by showing that substantial numbers of the same item of property were sold for cash at the same price to other purchasers.

We believe that the regulatory authority in the current statute is broad enough to allow us to address these situations. However, we would welcome legislative confirmation of this authority on these particular points.

IV

ASSUMPTIONS OF EXISTING INDEBTEDNESS

1. Background

The last major issue that I would like to address today concerns the treatment of assumptions of existing indebtedness on property. The problem, simply stated, is that when property is sold and, as part of the consideration for the sale, the buyer assumes liability for an indebtedness with an interest rate that is below a market rate at the time of the sale, the same potential for overstatement of purchase price is present as in the case where the indebtedness is seller financing.

The problem may be illustrated by the following example. Suppose A, a commercial lender, lends $100 to B at 12%, which is a market interest rate at the time of the loan. B uses the $100 to purchase depreciable property and secures the note with the property. Some time later, when market interest rates have risen to 15%, B sells the property to C. The fair market value of the property, if unencumbered, remains at $100. However, because C is able to assume B's favorable indebtedness to A, C is willing to pay a total purchase price of $120, that is, C assumes B's $100 debt to A and pays B $20 in cash.

The extra $20 that C is willing to pay B has nothing to do with the value of the property sold; it simply reflects the fact that B's obligation to A is less of a liability because of the

increase in interest rates. If the imputed interest rules do not apply to this transaction, C will be able to write off the extra $20 as depreciable basis. If the term of the debt is longer than the ACRS life of the property, this gives a significant advantage to C.

The seller B also benefits from the overstated basis in the following way. B originally owed $100 to A. When the property securing the debt was sold, B gave up property worth $100 in exchange for $20 in cash and C's assumption of B's debt. Thus, B's $100 debt to A was discharged in effect at a net cost to B of only $80. This $20 difference could be properly viewed as ordinary income from cancellation of indebtedness. Instead, unless the imputed interest rules apply to assumptions, C has additional capital gain of $20.

2. Possible Approaches

Several possible approaches have been suggested for dealing with these problems. These may be referred to as the novation approach, the wraparound approach, and the anti-abuse approach.

a. Novation - The novation approach treats an assumption as if the existing debt were repaid upon sale and a new debt issued by the original lender to the buyer. Thus, in the above example, the buyer C would have a depreciable basis of $100 and additional interest deductions of $20 over the life of the loan and the seller B would have ordinary income from the cancellation of indebtedness of $20. To complete the picture, the original lender A should be given a bad debt deduction of $20 to match B's income inclusion and would have interest income of $20 over the remaining life of the loan to match C's interest deductions.

b. Wraparound - The wraparound approach treats an assumption as if the seller remained liable on the original debt and issued new seller financing to the buyer. This approach has appeal primarily where the seller in fact remains secondarily liable on the assumed debt. In terms of the example, the treatment of the buyer C would be the same but the seller B would have interest income of $20 spread over the remaining life of the loan instead of at the time of the sale. The original lender A would be unaffected.

c. Anti-abuse - The anti-abuse approach focuses exclusively on the buyer C and attempts to foreclose the conversion of interest deductions into depreciation deductions in situations where this conversion would present a significant tax advantage. Under this approach, an assumed debt would be subject to the imputed interest rules only if the property securing the debt were depreciable in the hands of the buyer and only if the remaining term of the debt were sufficiently long, when compared to the ACRS life of the property, to indicate that the revenue

loss from the basis overstatement would be significant. The seller and the original lender would be treated as under present law.

3. Recommendation

Each of the three possible approaches outlined above presents certain advantages and disadvantages. The novation approach and the wraparound approach both entail the matching of income and deductions and hence would be quite effective in preventing abuse. However, the novation approach is difficult to justify if the consent of the original lender is not required for the assumption. The wraparound approach would seem to be correct only where the seller remains secondarily liable on the assumed debt and presents significant issues relating to the timing of the seller's gain under the installment sale rules. Moreover, adoption of either of these approaches arguably would require a broad-based reexamination of fundamental principles relating to cancellation of indebtedness income, market discount, and other aspects of the taxation of financial contracts, an inquiry that would not seem advisable at the present time.

We would suggest, therefore, that the Committee give its primary attention to the formulation of an anti-abuse rule along the lines described above. We would be happy to work with the Committee in the design of such a rule. Of course, the rule would apply only to assumptions of post-October 15, 1984 indebtedness. We see no reason to move this date forward since the anti-abuse rule would apply to a more limited class of taxpayers than those covered by P.L. 98-612.

* * *

This concludes my prepared remarks. I would be happy to answer your questions.

Chart 1

Private and Government Interest Rates

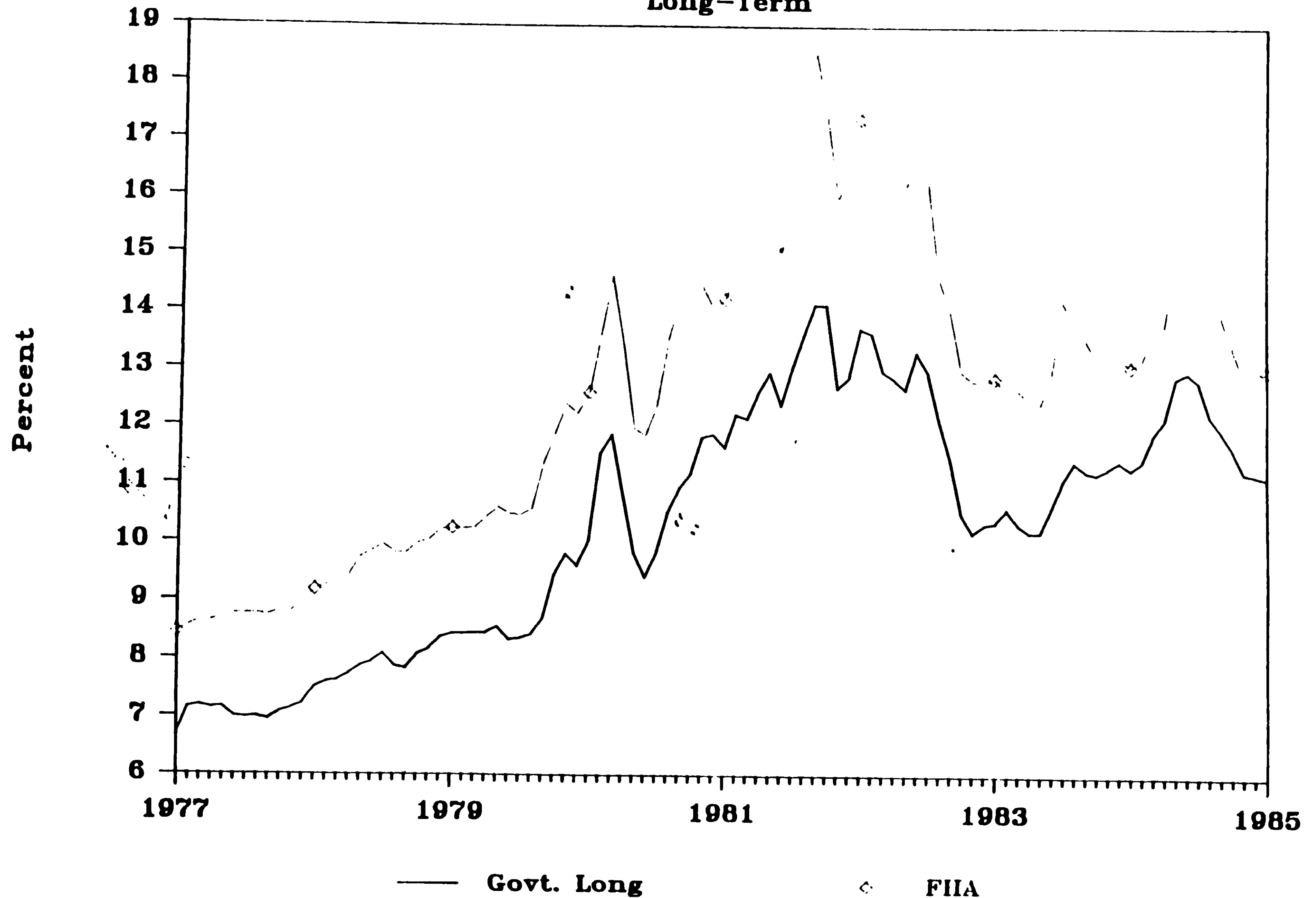
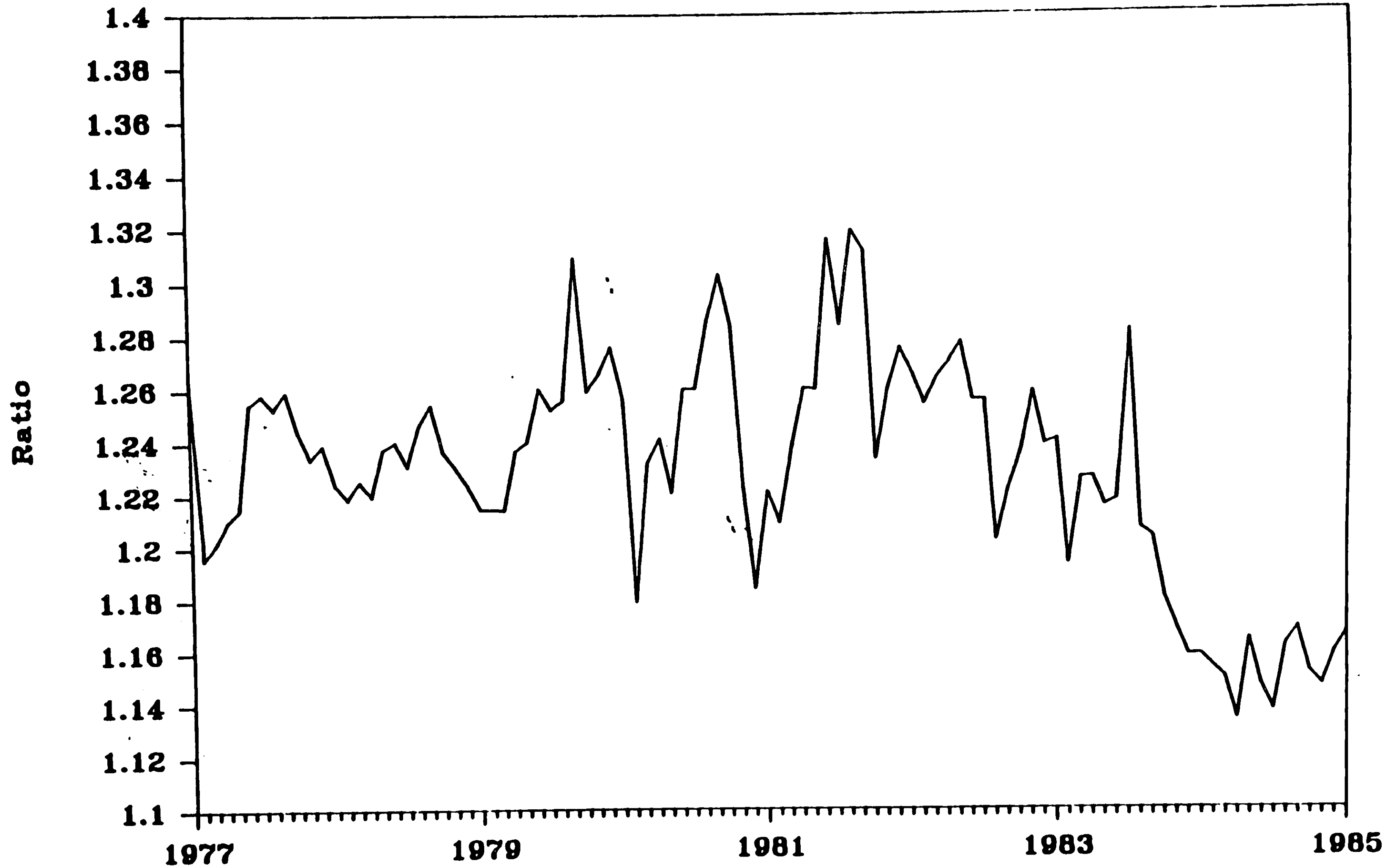


Chart 2



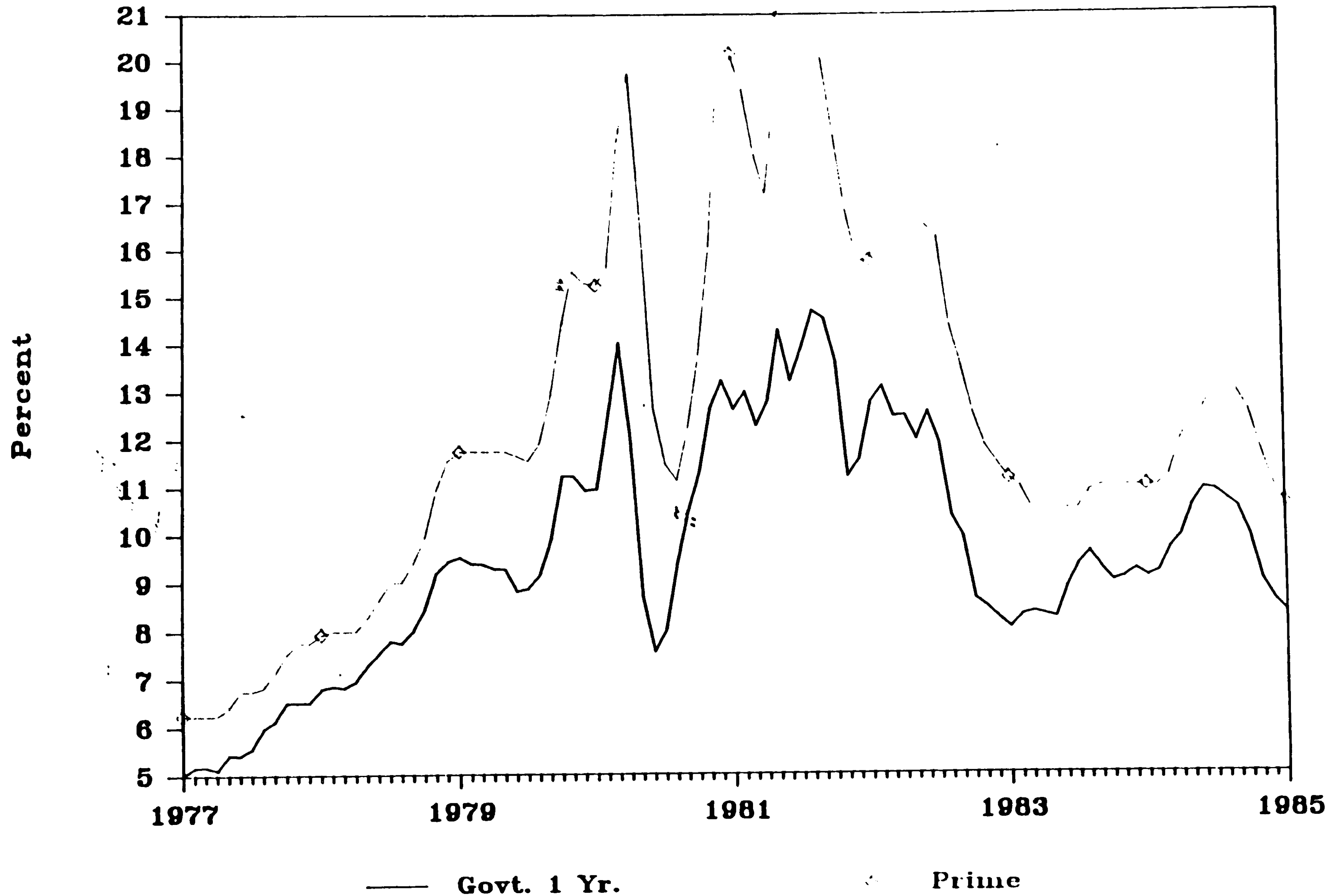
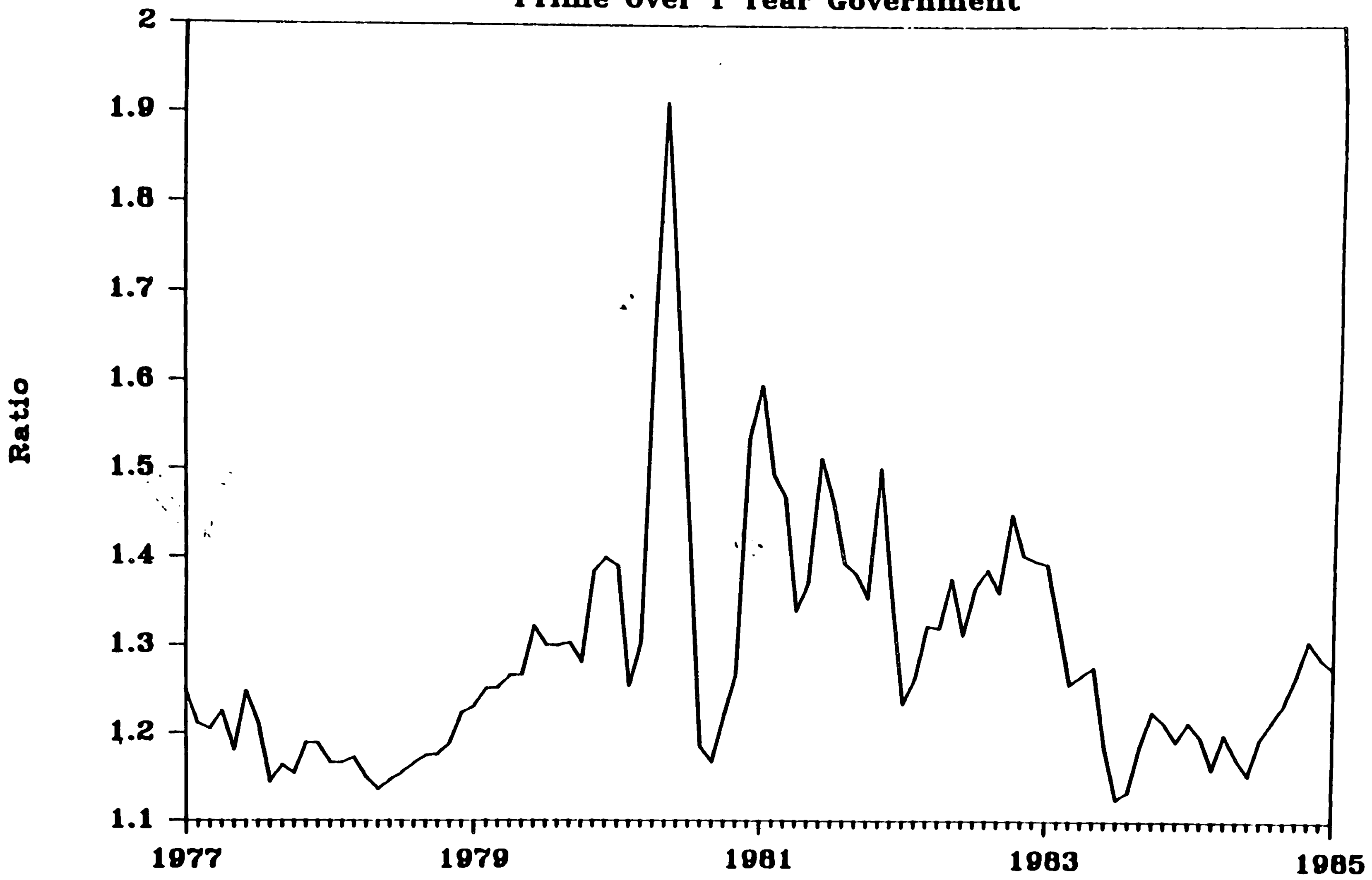


Chart 3
Private and Government Interest Rates
Short-Term
Percent
21
20
19
18
17
16
15
14
13
12
11
10
9
8
7
6
5
1977
1979
1981
1983
1985
Govt. 1 Yr.
Prime

Chart 4



TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

April 24, 1985

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $ 9,026 million of $ 20,622 million of tenders received from the public for the 2-year notes, Series U-1987, auctioned today. The notes will be issued April 30, 1985, and mature April 30, 1987.

The interest rate on the notes will be 9-3/4%. The range of accepted competitive bids, and the corresponding prices at the 9-3/4% interest rate are as follows:

	Yield	Price
Low	9.80%	99.911
High	9.82%	99.876
Average	9.81%	99.893

Tenders at the high yield were allotted 86%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 415,495	$ 58,425
New York	17,169,565	7,617,370
Philadelphia	44,860	44,860
Cleveland	305,815	254,575
Richmond	106,420	78,430
Atlanta	109,705	89,445
Chicago	986,850	312,110
St. Louis	116,210	109,650
Minneapolis	116,710	88,570
Kansas City	139,850	138,750
Dallas	25,390	21,110
San Francisco	1,076,065	203,185
Treasury	9,185	9,185
Totals	$20,622,120	$9,025,665

The $9,026 million of accepted tenders includes $1,216 million of noncompetitive tenders and $7,810 million of competitive tenders from the public.

In addition to the $9,026 million of tenders accepted in the auction process, $523 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $347 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

Mr. Secretary, Distinguished Delegates, Guests and Friends of long standing:

On behalf of the members of the Saudi delegation, I would like to express my great pleasure to be here in Washington, D.C. to attend this Ninth Session of the Saudi Arabian - U.S. Joint Commission on Economic Cooperation. I would like to extend a warm welcome to Secretary James A. Baker III who is participating for the first time in this forum. We look forward to working with you, Mr. Secretary, in your capacity as Co-Chairman of the Joint Commission.

I would also like to note that this ninth session marks the fifth annual meeting of the Businessmen's Dialogue -- held within the framework of the Joint Commission. We are delighted to have the participation of the Saudi-U.S. Businessmen, and I wish to thank them for enriching our discussions, and we look forward to their reports and recommendations.

This meeting comes at a critical time in the history of both the Joint Commission and Saudi Arabia. This meeting is the first to be held after the second renewal of the Joint Commission Agreement earlier this year. On the one hand, the renewal of this agreement marked a decade highlighted by fruitful cooperation -- and a strengthening of the ties of friendship between our two

countries. On the other hand, this meeting, more than any other, heralds a new decade of promise-filled years and underlines our continued and determined commitment to the goals of the Joint Commission.

The first decade of the Joint Commission coincided with the implementation of three ambitious five-year economic plans in our country. These plans aimed at transforming our country from a near-total dependence on crude oil to a more diversified economy. These plans focused on the development of basic infrastructure, efficient financial and administrative institutions and export-oriented industries -- all of which lay the foundation for a solid, production-based growth economy.

During this first ten-year period, about 30 different programs were implemented through the Joint Commission. These programs have covered such essential and diverse areas as technical training, agricultural diversification, water resource development, the development of national statistics, customs, consumer protection, highway maintenance, financial and economic information, solar energy and national parks. Most recently, we have added projects in the areas of tax assistance and training, emergency medical services, space research of technology and meteorological systems support. Currently, there are about 251 American personnel engaged in various aspects of these programs.

..../3

Our investments in basic industries, infrastructure organization and the like have just started to pay off. Their real impact on the growth of our economy has just begun to unfold,and the future gains from such investments should reflect Saudi progress in the years to come.

During fiscal year 1983/84 alone, despite a 31 percent fall in the Kingdom's oil revenues, due to a continued weakness in the oil market, the real non-oil gross domestic product still grew by 5 percent. At the same time, the private sector has been active, registering a real rate of growth of almost 8 percent. There was also a 12 percent rise in the growth rate of the agricultural sector compared with 10 percent in the preceding year, while the manufacturing sector has sustained a higher growth rate of 16 percent. At the same time, inflation was successfully tamed to encourage real growth within an environment of stable prices. In addition, the Saudi economy will grow in the years to come less and less dependent on government spending which was the driving force behind our economy during the previous years.

As you can see then, this meeting takes place during a historic transition in the Saudi Arabian economy. We are emerging from a construction-based growth economy into a more solid, production-oriented economy.

..../4

The recent announcement of the Fourth Five-Year Development Plan marks a new era of investment opportunity and prosperity in the Kingdom. This era will offer new challenges and demands for the Joint Commission. Within the framework of the Fourth Development Plan, the private sector will be given the opportunity to undertake many of the economic tasks previously undertaken by the Government. Accordingly, this will provide a wide range of profitable investment unavailable previously.

While many of the objectives of the Fourth Plan are continuations of the principles and policies of the Third Plan and its predecessors, there are several themes which differentiate it from previous plans. In particular, the Kingdom of Saudi Arabia is especially concerned with the efficiency of operations and with economic diversification. To achieve this we are placing a definite emphasis on promoting private sector involvement in economic development.

To this end, joint ventures will constitute a major vehicle within the private sector for investment and industrial diversification. As our diversification moves forward, accelerated inputs of technology will be needed not only in manufacturing and engineering, but also in marketing expertise.

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In order to assume this role and to make use of the best possible management and technology, we continue to actively seek joint ventures with U.S. companies who are interested in our market and who wish to participate in the challenges and rewards of our spectacular growth.

In particular, we look to the Joint Commission to play a greater role in the transfer of this technology and expertise. This will primarily take place through the direct involvement between Saudi Government agencies and their counterpart agencies in US Government, which would also stimulate joint projects and ventures.

I sincerely hope that American business will continue its strong participation in our private sector growth and that American business will continue to be the most important source of foreign joint venture partners in Saudi Arabia.

We are happy to see the importance the U.S. Government attaches to the need for trade liberalization, for we also believe that this will contribute to the improvement of world trade and economic conditions. We strongly feel that an environment should be created where products of various countries will have reasonable access to relevant markets.

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It was with great interest, in this general spirit, that the Government of Saudi Arabia saw that the OECD Secretariat and the Organisation as a whole is interested in the matter of petrochemicals and that they see the importance of a balanced development of trade in these products in the years to come.

I want to express, in the name of the Government of Saudi Arabia, our sincere interest in this field and I hope that some form of consultation with my country and other countries of the GCC can be developed in time.

In closing, I want to re-emphasize my conviction that the Joint Commission is playing an important role in Saudi Arabian development. The course that we have set for the future offers even greater opportunities for Joint Commission involvement as we move into the years ahead.

Your thoughtful and enthusiastic discussion of the items on our agenda and your ideas and recommendations at this Ninth Annual Meeting thus will help improve the quality and productivity of our Joint Commission and set the direction of its activities in the years to come.

Thank you.

* * * * *

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 a.m., E.D.T.
April 25, 1985

STATEMENT OF
MIKEL M. ROLLYSON
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE OF THE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the provisions of S. 972, which contains the Administration's proposal for funding the reauthorization of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"). CERCLA established and provides funding for the Hazardous Response Trust Fund, the "Superfund," which is recognized as the Federal Government's primary program for addressing dangerous environmental and health conditions created by the release of hazardous substances into the environment.

I want to emphasize this Administration's continuing commitment to protecting the public and the environment from the release or improper disposal of hazardous chemical substances. As the President stated in his recent State of the Union Address, reauthorization of Superfund is a top Administration priority. The Environmental Protection Agency ("EPA") has submitted a statement that describes the level of funding required for the Superfund and how those funds should be expended. It is our belief that the provisions of S. 972 provide an adequate, stable, and equitable financial base for the Superfund.

BACKGROUND

CERCLA provides the Federal Government with the authority to clean up hazardous substances released into the environment, to pay for restoration of natural resources caused by such substances, and to recover the costs of such cleanup and restoration from the parties responsible for releasing the hazardous substances. The response program is administered by the EPA and is financed by the $1.6 billion Superfund.

CERCLA authorizes appropriations to the Superfund equal to $44 million per year for fiscal years 1981 to 1985. The Superfund is principally funded, however, by excise taxes on crude oil, petroleum products, and certain specified chemicals. Section 4611 of the Internal Revenue Code imposes an excise tax of .79 cent a barrel on domestic crude oil received at a United States refinery or exported, on imported crude oil and petroleum products entered into the United States for consumption, use, or warehousing. Section 4661 of the Code imposes an excise tax on 42 listed chemicals sold or used by the manufacturer, producer, or importer of the listed chemicals. These taxed chemicals are either themselves hazardous or are the basic chemical components of nearly all other major inorganic and organic hazardous substances and hazardous wastes. The tax is assessed at rates ranging from 22 cents per ton to $4.87 per ton depending upon the chemical. The tax rates for crude oil, imported petroleum products, and the listed chemicals reflect a Congressional decision to allocate 65 percent of the Superfund tax burden to petrochemicals, 20 percent to inorganic chemicals, and 15 percent to crude oil and imported petroleum products. This allocation was based on estimates of hazardous waste generated by these broad industry segments at the time of enactment of CERCLA. The rate of tax on any chemical, however, is limited to two percent of its wholesale price as of 1980, and in many cases is much less.

CERCLA imposes upon those who generate, transport, or dispose of wastes, the liability for damages caused by a release or threatened release of hazardous substances. Hazardous substances are defined to include those hazardous substances specified under various other environmental statutes as well as substances that EPA determines present substantial danger to the public health or welfare or the environment. Responsible parties may be held strictly, jointly, and severally liable for all response costs associated with removal and cleanup of hazardous substances releases and damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss.

Liability limits are fixed by statute. Generally, liability is limited to response costs plus $50 million. The liability limitations do not apply, however, if the release or threatened

release is the result of willful misconduct or willful negligence or if the responsible person does not provide assistance and cooperation when requested by a public official. In addition, punitive damages up to three times the response costs incurred may be imposed if the responsible person fails without cause to provide remedial and removal action when ordered by the President.

CERCLA also established the Post-Closure Liability Trust Fund. This fund is obligated to pay all costs arising out of liability imposed by any law with respect to a hazardous waste disposal facility after its closure, provided the facility had received a permit under Subtitle C of the Solid Waste Disposal Act and complied with other regulatory requirements designed to protect against future releases of hazardous substances. Thus, if these prerequisites are satisfied, future liabilities arising from the closed facility are shifted from the responsible parties to the Federal Government. The Post-Closure Liability Trust Fund is funded with revenues collected under section 4681 of the Code, which imposes a tax on hazardous waste received at a qualified hazardous waste disposal facility. The tax is assessed at a flat rate of $2.13 per dry weight ton, and is imposed upon and collected from the owner or operator of the facility.

The authority to collect the taxes enacted by CERCLA, including the tax supporting the Post-Closure Liability Trust Fund, terminates on September 30, 1985.

DESCRIPTION OF THE PROVISIONS OF S. 972

S. 972 would fund a five-year, $5.3 billion Superfund by maintaining the existing level of excise taxes on crude oil, imported petroleum products, and currently listed feedstock chemicals ("feedstock taxes") and by imposing a tax on the management of hazardous waste ("waste management tax"). No chemicals would be added to or deleted from the list of taxed feedstock chemicals, and no change would be made to the present rate structure. The bill would not authorize appropriations from general revenues for the Superfund.

The parameters of the waste management tax component set forth in the Administration proposal were based principally upon a 1981 EPA survey of hazardous waste volumes and management practices. Since the introduction of the proposal, industry representatives have assisted us in revising and updating our data base. Based upon this new information, we are recommending that certain provisions of the waste management tax be modified. The following is a description of the revised Administration proposal.

The Administration proposal would impose an excise tax on the management of hazardous waste at a waste management unit subject to permit requirements under the Resource Conservation and Recovery Act ("RCRA"), effective October 1, 1985. The tax would be imposed on a wet weight basis on the receipt at a permitted waste management unit of any waste identified or listed under section 3001 of the Solid Waste Disposal Act as of the date of enactment. Wastes subsequently identified or listed as hazardous would not be subject to the tax, absent Congressional action. The tax also would be imposed on the ocean disposal of hazardous waste and on the transport of hazardous waste from the United States on or after October 1, 1985. The owner or operator of the permitted waste management unit or the exporter of the hazardous waste would be liable for the tax.

The tax would be assessed on the receipt of hazardous waste at a waste management unit subject to permit requirements under Subtitle C of the Solid Waste Disposal Act. The tax rates imposed would vary depending upon how the waste is managed. Hazardous waste received at waste water facilities would be taxed at a rate of 25 cents/ton over the reauthorization period; hazardous waste received at injection well facilities would be taxed at a rate of $5.00/ton over the reauthorization period; hazardous waste received at landfills, surface impoundments (other than impoundments contained in waste water or deep well injection facilities), waste piles, or land treatment units would be taxed at an initial rate of $35/ton, increasing to $40/ton over the five year reauthorization period; and hazardous waste received at all other permitted units would be taxed at an initial rate of $6.00/ton, increasing to $7.80/ton over the reauthorization period. The bill contains a formula for adjusting the scheduled rates beginning October 1, 1987 if amounts credited or appropriated to the Superfund for preceding fiscal years fall below projected revenues for the period. The authority to collect taxes would terminate when the sum of the amounts credited or appropriated to the Superfund during the reauthorization period total $5.3 billion. To ensure against subjecting the same volume of waste to multiple taxes, a credit would be provided for taxes paid with respect to hazardous wastes that are transferred from one permitted waste management unit to another.

The tax would not be imposed with respect to hazardous wastes that are not managed in permitted waste management units, to certain wastes generated prior to the date of enactment that are received at permitted waste management units from CERCLA required removal or remedial actions or from RCRA corrective actions, or to wastes generated by Federal facilities.

The provisions of CERCLA that establish the Post-Closure Liability Trust Fund would be repealed by S. 972, effective October 1, 1985, and the Post-Closure Liability Trust Fund would

be terminated as of that date. Liability for certain damages from the release or threatened release of hazardous waste from waste sites after their closure would therefore remain with the responsible parties for such facilities. Taxes already collected from owners and operators of qualified hazardous waste disposal facilities under Code section 4681 would be transferred to the Superfund.

In summary, under the Administration proposal the Superfund would be funded by revenues generated by the existing excise taxes on crude oil, imported petroleum products, and feedstock chemicals, and by an excise tax on the management of hazardous waste.

DISCUSSION

Maintenance of the Current Feedstock Taxes

The Administration proposal would extend through September 30, 1990 the current excise taxes on crude oil, imported petroleum products, and 42 listed chemicals sold or used by the manufacturer, producer, or importer of chemicals. The feedstock taxes enacted by CERCLA reflect the policy decision that Federal Government action taken to clean up and contain spills or threatened or actual releases of hazardous substances, and the payment of damage claims when responsible parties are not known should be funded by the producers and users of hazardous substances rather than by the general public. The feedstock taxes have been criticized on the grounds that the tax collected from any individual firm is not based upon that firm's actual experience with hazardous substances and provides at best a form of rough justice. While these criticisms are not without merit, the taxes were imposed in recognition of the fact that there are present and future environmental costs associated with the use of hazardous substances. Prior to the enactment of CERCLA, however, these costs were not reflected in the price of the products made from such substances. By taxing the basic building materials used to make hazardous products and waste, these costs are borne by those persons utilizing hazardous materials.

Moreover, the taxed chemicals or derivative products of those chemicals appear in the response sites now being investigated by EPA. A nexus thus exists between the manufacture or use of the taxed chemicals and Superfund expenditures. It has been suggested that the list of chemicals subject to tax should be expanded to include other chemicals that have appeared in EPA response sites. We do not favor that approach. New sources of funds to support the Superfund should come, if possible, from taxes on the very substances that pose a threat to human health and the environment. We believe the waste management tax authorized in the Administration proposal would be more efficient than the feedstock taxes in taxing directly those persons that create hazardous wastes.

Finally, the feedstock taxes provide a stable source of revenue for the Superfund. Currently, revenues from these taxes total approximately $300 million per year. The Internal Revenue Service has not encountered substantial difficulties in administering the feedstock taxes.

Waste Management Tax

The Administration proposal would impose a tax on the receipt of hazardous waste at a unit subject to RCRA permit requirements that treats, stores, or disposes of the waste. We estimate that this tax would raise approximately $600 million per year.

The waste management tax would be paid by the industries that generate the hazardous waste believed to be responsible for many of the existing Superfund sites. Because a closer nexus exists between the generation of hazardous waste and Superfund spending than between the use or production of feedstock chemicals and Superfund spending, this tax more appropriately allocates the environmental costs associated with the use or production of hazardous substances. Data we have received from various industries indicates that the waste management tax would be borne to a large extent by the same taxpayers who currently pay the feedstock taxes. The tax would expand somewhat the number of taxpayers who are funding the Superfund, however, as it would be imposed on a number of taxpayers that are not subject to the feedstock taxes.

Other legislative proposals for the reauthorization Superfund would tax the general public by appropriating funds from general revenues or tax corporations whose practices may have no connection to the problems that Superfund addresses. These broad based taxes have the support of those industries that are subject to the feedstock taxes and those that are expected to pay the waste management tax. We understand the interest these industries have in urging Congress to enact a broad based tax. We, however, support the Congressional decision made at the time of the enactment of CERCLA to fund Superfund expenditures by imposing the environmental costs of using hazardous substances on the industry segment that uses or produces such substances. The Administration proposal, therefore, relies upon the waste management tax as the principal funding source for Superfund while maintaining the existing feedstock taxes.

The waste management tax, by taxing the treatment, storage, and disposal of hazardous waste, is consistent with the EPA regulatory program. The regulation of the treatment of hazardous waste, as well as the regulation of disposal and storage of hazardous waste, under the Solid Waste Disposal Act, reflects the Congressional determination that there are risks associated with the management of hazardous waste. Under the proposed waste management tax, the lowest tax rates are imposed upon waste water

treatment and deep well injection. Each of those waste management techniques involve the use of large volumes of water; the lower rates reflect the dilute concentrations of hazardous waste commonly associated with those such management techniques. Higher rates are imposed upon the management of concentrated wastes. The highest rate is imposed on the treatment, storage, or disposal of concentrated hazardous waste in or on the land, i.e., in landfills, waste piles, land treatment units, and surface impoundments (other than those contained within waste water or deep well injection facilities).

The tax would be based upon the wet weight tonnage of a hazardous waste received at an interim status or permitted waste management unit and collected from the owner or operator of the waste management unit. Measuring the tax by reference to wet weight tonnage, as opposed to dry weight tonnage, has several advantages. From an environmental standpoint, the wet weight approach is more consistent with the EPA regulatory program and the Congressional decision to encourage taxpayers to reduce the volumes of hazardous waste. A dry weight approach also would ignore the fact that many wastes are extremely toxic at low concentrations. Finally, the wet weight approach will be significantly easier to administer.

At present, there are approximately 5,000 facilities with permitted units. Due to the relatively small number of potential taxpayers, we believe this tax could be administered without difficulty. The Internal Revenue Service has estimated that the cost of implementing the tax would not exceed $100,000.

Superfund expenditures during the reauthorization period would be committed based upon amounts projected to be credited or appropriated to the Superfund during each fiscal year. To assure that funds are available as needed, the bill permits EPA to borrow from other Federal sources if revenues fall below projected levels and sets forth a detailed formula based upon actual receipts for adjusting the waste management tax rates beginning in October of 1987 to make up any such shortfall.

In summary, the Administration proposal would provide principal funding for a five-year, $5.3 billion Superfund by imposing a tax on a wet weight basis on the management of hazardous wastes in interim status or permitted units. Additional funding would be obtained from the maintenance of the existing level of excise taxes on crude oil, imported petroleum products, and currently listed feedstock chemicals.

* * *

This concludes my prepared remarks on the provisions of S. 972. I would be happy to respond to your questions.

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TREASURY NEWS

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CUBA EMBARGO VIOLATION GUILTY PLEA
UNITED STATES v. PETER D. YATRAKIS

PETER D. YATRAKIS pleaded guilty today in the United States District Court for the Southern District of New York to violating the Trading With the Enemy Act in connection with his commercial dealings with Cuba from 1981 to 1983. Mr. Yatrakis leased vessels to Cuban firms for the transport of Cuban cargoes.

No date was set for the sentencing of Yatrakis, who could receive a maximum sentence of 10 years in prison and a $50,000 fine. Pending sentencing, Yatrakis is released on bail.

Rudolph W. Giuliani, United States Attorney for the Southern District of New York and John M. Walker, Jr., Assistant Secretary of the Treasury for Enforcement and Operations, jointly announced this plea. Secretary Walker stated that this case represented part of his department's policy to strictly enforce United States embargo regulations against Cuba and the other embargoed countries (North Korea, Vietnam, and Kampuchea).

Civil litigation concerning the sinking of the vessel RAGNAR, owned by Yatrakis, while en route with Cuban cement bound for Libya helped precipitate this investigation.

According to Steven M. Kaplan, the Assistant United States Attorney in charge of this case, Yatrakis was the owner of a number of firms operating out of lower Manhattan and engaged in the international maritime freight shipping business. During a period running from April of 1981 through February 1983, Yatrakis time chartered (leased for a period of time) a number of ships owned or operated by those

firms to companies controlled by the Cuban government for the express purpose of transporting Cuban cargo--usually construction material--from Cuba. These goods were shipped by Yatrakis' vessels to a number of destinations including Libya and Grenada. Since July 8, 1963 to the present time, the United States embargo on trade with Cuba has barred persons subject to U.S. jurisdiction from transporting goods to or from Cuba or engaging in any other unauthorized dealings in Cuban property.

Both Mr. Giuliani and Secretary Walker commended the work of the United States Customs Service and the Office of Foreign Assets Control on this case. They further noted that this investigation is continuing, and that additional indictments are expected.

Yatrakis, 44 years old, resides in Brooklyn, New York.

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